183

S. HRG. 103–510

MUTUAL-TO-STOCK CONVERSIONS—S. 1801

Y 4. B 22/3: S. HRG. 103-510

Mutual-to-Stock Conversions-S.1801,...

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

S. 1801

TO APPLY CERTAIN MINIMUM STANDARDS TO THE CONVERSION OF SAVINGS ASSOCIATIONS AND SAVINGS BANKS FROM THE MUTUAL FORM TO THE STOCK FORM, AND FOR OTHER PURPOSES

FEBRUARY 25, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

JUL 19 1994

U.S. GOVERNMENT PRINTING OFFICE

78–701 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044263-X

183

S. HRG. 103-510

MUTUAL-TO-STOCK CONVERSIONS—S. 1801

Y 4. B 22/3: S. HRG. 103-510

Mutual-to-Stock Conversions-S. 1801,...

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

S. 1801

TO APPLY CERTAIN MINIMUM STANDARDS TO THE CONVERSION OF SAVINGS ASSOCIATIONS AND SAVINGS BANKS FROM THE MUTUAL FORM TO THE STOCK FORM, AND FOR OTHER PURPOSES

FEBRUARY 25, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

JUL 19 1994

U.S. GOVERNMENT PRINTING OFFICE

78-701 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044263-X

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, JR., Michigan, *Chairman*

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
JIM SASSER, Tennessee
RICHARD C. SHELBY, Alabama
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada
BARBARA BOXER, California
BEN NIGHTHORSE CAMPBELL, Colorado
CAROL MOSELEY-BRAUN, Illinois
PATTY MURRAY, Washington

ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
LAUCH FAIRCLOTH, North Carolina
ROBERT F. BENNETT, Utah
WILLIAM V. ROTH, JR., Delaware
PETE V. DOMENICI, New Mexico

STEVEN B. HARRIS, *Staff Director and Chief Counsel*
HOWARD A. MENELL, *Republican Staff Director*
SHARON HEATON, *Counsel*
MARK A. KAUFMAN, *Financial Policy Analyst*
STEFANIE LAKO, *Professional Staff Member*
RAYMOND NATTER, *Republican General Counsel*
LAURA SIMONE UNGER, *Republican Counsel*
EDWARD M. MALAN, *Editor*

CONTENTS

FRIDAY, FEBRUARY 25, 1994

	Page
Opening statement of Chairman Riegle	1
Opening statement of Senator D'Amato	2
Prepared statement	94
Proposed bill S. 1801	85

WITNESSES

Andrew C. Hove, Acting Chairman, Federal Deposit Insurance Corporation, Washington, DC	3
Prepared statement	33
The question of "Ownership"	33
Participation in conversions	34
Appraisals	34
Use of proceeds	34
Numerical examples	34
Use of stock purchase rights	36
Merger conversions	36
Reforming the process: Preliminary thoughts	36
Proposed legislation	38
Response to written questions of Senator Riegle	71
Jonathan L. Fiechter, Acting Director, Office of Thrift Supervision, Washington, DC	5
Prepared statement	39
Introduction	40
Overview of the mutual-to-stock conversion process	40
History of the Federal conversion regulations	41
Key safeguards contained in OTS conversion rules	42
Conversion regulation issues	43
S. 1801, The Mutual Depository Institution Conversion Protection Act of 1994	44
Conclusion	44
Response to written questions of Senator Riegle	74
Response to oral questions of Senator D'Amato	95
Derrick D. Cephas, superintendent of banks, State of New York, New York City, NY	15
Prepared statement	45
I. Who owns a mutual institution?	45
II. What parties, if any, should receive priority rights in a conversion?	45
III. To what extent should management and insiders be allowed to participate in a conversion?	45
IV. How effective is the current appraisal process?	46
V. Do sufficient safeguards exist?	46
VI. What issues are raised in merger conversions?	46
Additional statement	47
Response to written questions of Senator Riegle	72

Page

William J. Drumm, superintendent, Division of Savings and Loan Associations and Division of Savings Banks, State of Ohio, Columbus, OH 17
Prepared statement 52
Background information 52
Increasing capital requirements and the savings bank charter 53
Savings bank regulations 53
Mutual ownership of savings banks 53
Mutual-to-stock conversion activity 54
Summary discussion 54
Response to written questions of Senator Riegle 80
David E. A. Carson, chairman, president, and chief executive officer, People's Bank, Bridgeport, CT; testifying on behalf of Savings and Community Bankers of America 19
Prepared statement 61
Response to written questions of Senator Riegle 82
Chris Lewis, banking and housing policy director, Consumer Federation of America, Washington, DC 21
Prepared statement 66
Principle concerns 66
Growing problem 67
The insider's outside friends 67
Supervision? 68
Recommendations on S. 1801 68
Conclusion 69
Response to written questions of Senator Riegle 82

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Hobart and William Smith Colleges 91
Federal Register, May 3, 1994:
Office of Thrift Supervision, Treasury;
Interim final rule with request for comments 97
Proposed rule 108

MUTUAL-TO-STOCK CONVERSIONS

FRIDAY, FEBRUARY 25, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met in room 538, of the Dirksen Senate Office Building at 10:12 a.m., Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance this morning. I see some faces that I saw yesterday here. So, welcome back.

We are meeting this morning to conduct a hearing on the issue of mutual-to-stock bank conversions.

Senator D'Amato and I recently introduced S. 1801, which is entitled the Mutual Depository Institution Conversion Protection Act, in order to address insider abuses in these transactions. Unlike stock institutions, mutual depository institutions are nominally owned by their depositors. As such they are able to raise capital only through retained earnings. This can be problematic particularly if the mutual institution is not profitable. By converting to stock form, hundreds of such institutions have been able to obtain over $16 billion in vital capital in the last 20 years.

More recently, however, management and insiders at well-capitalized mutuals appear to be abusing the conversion process to reap substantial personal gain. Generous stock and option plans for insiders have become commonplace, along with systematic underpricing of the conversion stock itself.

I am particularly concerned by reports that some mutuals are switching from Federal to State charters in order to take advantage of more-lax State conversion rules. This sort of competition in laxity benefits no one, and is, at least, not in the public interest and should not be tolerated.

The bill that Senator D'Amato and I have introduced represents a measured response to these problems. It is not designed to eliminate conversions but rather to ensure that proper incentives drive the transactions. The bill would establish Federal regulations as the floor for all conversions but allow the States to adopt further restrictions as they desire. At the same time, it limits management and insiders to benefits available to all eligible depositors in a conversion. If there are depositors, management may receive the same preferential treatment provided to other depositors and nothing more than that.

Finally, the bill prohibits the institution from approving compensation proposals for management such as stock options packages for 1 year. Such incentive compensation is best evaluated after a conversion by stockholders who truly own the converted institution.

The Federal Deposit Insurance Corporation and the Office of Thrift Supervision have moved to stop some of the abuses in mutual-to-stock conversions. The OTS has announced a general review of its regulations and a moratorium on conversions involving mergers. At the same time, the FDIC, as the Federal regulator of State-chartered mutual savings banks, has announced that it will "generally" apply the OTS regulations to conversions of State-chartered institutions.

While I commend the regulators for their actions, more work needs to be done here. The FDIC proposal remains vague, and it lacks measurable standards for evaluating a proposed conversion. More generally, questions have also been raised about the extent of the agency's statutory authority to regulate conversions. For its part, the OTS has not yet announced the changes it will consider to its conversion process. Until these issues are settled, we will continue to press forward with legislation in this area.

I want to take this opportunity to express my appreciation to my good friend and distinguished colleague, Senator D'Amato. Our work on this issue, as so many others, has been truly a bipartisan effort, and we will continue to work together in that fashion.

So, I want to welcome our witnesses, and before we go to them, let me call on Senator D'Amato.

OPENING COMMENTS OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. I am going to ask in the interest of time that my full statement be entered into the record as if read in its entirety.

The CHAIRMAN. Without objection, so ordered.

Senator D'AMATO. Mr. Chairman, my own State of New York has dealt with the problem, and I think, to put it succinctly, what we are really trying to do is say that conversions for the most part are beneficial. I know Senator Riegle joins with me. If we can get capital into the system, we want to do that. But a handful of people on certain occasions should not be blinded by their being able to make windfall profits at the expense of the depositors. That is not what this is about. And that is just wrong.

Let me say to the Banking Commissioner of New York—Derrick Cephas—I think you did an outstanding job in stopping what would have been one of those situations where basically a handful of insiders would have just made a huge windfall, not in regard to service or whatever, but just because they were able to control the process. Again, that is wrong.

So that is what this is an attempt to deal with: keeping people from taking advantage of the system that was not intended to enrich them. If stockholders later want to give them compensation, fine. But when the depositors in these mutuals have little, if any, power, they have to have certain protections. That is what we really seek to do. We are not saying this is all perfect. We are not say-

ing that this bill is written in stone. It certainly isn't. But that is where I am coming from, in any event.

Now, I don't know if my staff is going to go at me later for saying that, but that is the way I feel about it.

So, staff, forgive me.

[Laughter.]

The CHAIRMAN. This morning we have got Jonathan Fiechter, who is the Acting Director of the Office of Thrift Supervision, here with us. And we also have the Acting Chairman of the FDIC, Andrew Hove, whom we had, of course, yesterday.

Gentlemen, we will make your full statements a part of the record.

Senator D'AMATO. Mr. Chairman, I just would like to take this opportunity because, you know, Mr. Hove was under a lot of pressure. This room at this time yesterday was a cauldron, and I want to tell you I think he has been a dedicated public official. Let us make no mistake about that.

But I want to thank you for your response as it relates to the Whitewater matter that you have indeed directed the Inspector General to review those issues that we called to your attention. And today he has advised me and the Chairman of that with a letter. So let me underscore the fact that I want to commend you for moving as you have.

The CHAIRMAN. Mr. Hove, why don't we start with you?

STATEMENT OF ANDREW C. HOVE, ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC

Mr. HOVE. Thank you very much, Chairman Riegle and Senator D'Amato. On behalf of the Federal Deposit Insurance Corporation, I appreciate this opportunity to testify regarding institutions that convert from mutual-to-stock form.

I believe there are important and difficult issues that need to be addressed with respect to conversions. Currently, the FDIC has an internal task force reviewing the entire conversion process. Members of this task force are conferring with staff at the Office of Thrift Supervision. We also have an interim regulation in place, and we have solicited comments from the public on both the interim regulation and a proposed policy statement on this subject.

Our interim regulation should permit the FDIC to halt the abusive practices that have recently plagued the conversion process and to protect more fully the interests of depositors in a converting institution.

However, we have to do more than simply curb abuses in the current process. We need to reexamine the process generally to determine whether it should be redesigned and, if so, how best to achieve that result. In our experience, conversion is often a very good idea for the institution in question. It allows the weak institutions to recapitalize. It allows institutions to participate in a consolidation occurring in the bank and thrift industries.

There are major flaws in the existing conversion process as it operates when the institutions in question are healthy. The economic value of the converting institution flows to those who are wealthy enough and knowledgeable enough to stand in line to buy it. The

process may need to be redesigned so that the economic value can be distributed directly to those who should get it. Who should receive its value is ultimately a legal and political question for legislators.

The FDIC has several efforts under way with respect to mutual-to-stock conversions. First, we are reviewing conversion applications under our new interim regulation to determine whether to object to a transaction for safety and soundness reasons, violations of law or breaches of fiduciary duty. This process involves a case-by-case determination based upon the facts of each proposed conversion transaction. The current standards used in the FDIC's review of the proposed conversions under our new interim rule will not necessarily be affected by the potential long-term reforms mentioned in this testimony.

Second, we have formed a task force to review the entire conversion process, and we will work with the OTS on an approach for regulating the conversion process in the long term. While the task force has just begun its work, our testimony will outline our preliminary thinking on the issue, assuming the mechanics can be satisfactorily worked out.

No. 1, the essence of the conversion process should be a distribution to depositors, or others if they are deemed to be appropriate, of the transferable stock purchase rights, accompanied by appropriate disclosure documents.

No. 2, depositors should have a vote on the transaction even where State law does not require it. General proxies granted by depositors when they open accounts should not be valid.

No. 3, depositors' eligibility for receipt of rights should be based on an existing relationship of some specific duration. And that raises a host of issues that need further consideration.

No. 4, we are uncertain whether the distribution of rights should or should not reflect amounts on deposits, such as one right per $100 on deposit up to a maximum of ten rights per individual. Again, this subject calls for further study.

No. 5, the proxy statement and/or the disclosure statements should probably include the opinion of an independent financial adviser regarding the fairness of the transaction to depositors from a financial point of view. It should be clearly stated that this opinion does not address the question of whether the stock of the converting institution, or the acquirer in the case of merger conversions, is an appropriate investment for any particular depositor.

No. 6, as I indicated earlier, the ability of depositors and other recipients who do not wish to become stockholders to obtain fair value for their rights depends on the participation of underwriters or other dealers. We look forward to hearing from Wall Street and others about how the conversion process can be made fair and effective in this area.

No. 7, the amount of capital to be raised in the conversion process should be appropriate to the institution's condition and the reasonable business plan.

No. 8, the distribution of rights should not be a taxable event, but the basis of the rights in the hands of initial recipients should be zero, and they should be capital assets. When depositors or other recipients sell their rights and when they sell the underlying

shares, the Government will then obtain a portion of the economic value of the converting institution by taxing the gain on that sale.

No. 9, with depositor approval, the boards of converting institutions should be able to contribute some portion of the economic value of the institution by contributing rights to the new or existing charitable trusts or organizations whose focus is the community in which the institution serves.

No. 10, with the depositor approval, it should be possible to contribute rights to a qualified employee stock ownership plan.

No. 11, in addition to meeting the test of no excessive compensation, any awards to officers and directors at the time of the conversion should be in the form of stock, not options, to avoid the conflict of interest of negotiating a transaction with the objective of giving the stock as high a value as possible while having a personal interest in a low value.

No. 12, the merger conversion should, in essence, be exchanges of acquirer stock or cash for depositors' stock purchase rights. It should be feasible for potential acquirers to propose such transactions subject to appropriate State and Federal laws. And how this might work obviously requires further study.

Mr. Chairman, you asked for our comments on S. 1801, the Mutual Depository Institution Protection Act of 1994, which was introduced by you and Senator D'Amato. In that regard, I would make two comments.

First, we believe that the FDIC does, in fact, have sufficient authority to curb abuses in the current process. We would, however, need additional statutory authority if we proceed to reform the conversion process along some of the lines described above. We would strongly urge that our legislative mandate be general and that the details be allowed to emerge from our rulemaking process.

Second, we believe that the FDIC and the OTS should each retain responsibility for supervising conversions of those institutions for which each is primary Federal regulator, but will work together to assure comparable rules and procedures.

I thank you very much for the opportunity to testify, and I look forward to answering your questions.

The CHAIRMAN. Thank you.

Mr. Fiechter.

STATEMENT OF JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION, WASHINGTON, DC

Mr. FIECHTER. Good morning, Mr. Chairman and Senator D'Amato. Thank you for inviting me to provide the Office of Thrift Supervision's views on regulating mutual-to-stock conversions and on your bill, S. 1801. I want to compliment you, Mr. Chairman, on initiating hearings on this issue.

For the past 20 years mutual-to-stock conversions have been a successful vehicle for bringing new capital into the thrift industry. Since 1974 over 1,000 mutual savings associations have converted to stock institutions, in the process raising over $16 billion in new capital. As these numbers suggest, the principal benefit of an institution converting from the mutual to the stock form is raising capital, a result that can otherwise be difficult for mutuals to achieve. Unlike stock institutions, mutual associations can increase their

equity base only from retained earnings, and this can be a lengthy process.

In the last several years, mutual-to-stock conversions by healthy institutions have resulted in quick appreciations in the price of the stock. This makes the transaction attractive to the institution's insiders because of the opportunity to realize a profit, often a substantial profit, on any stock purchased by insiders in the conversion transaction. It is one of the focal points of OTS regulation.

The conversion from mutual-to-stock ownership creates several concerns. In a mutual-to-stock conversion, the mutual's insiders, its officers and directors, are the parties who initiate and set the terms for the sale of the stock. But they are also potential purchasers of the stock. They, like any purchasers, are motivated to buy low in order to maximize the stock's value to them in the aftermarket.

The account holders, who have an ownership interest in the mutual institution, are also potential stock purchasers. As such, they too benefit from the stock's appreciation in the after-market. Thus, when a mutual institution converts to stock form, the transaction is one-sided. There are typically motivated buyers for the stock, but in a conversion there are no typically motivated sellers. The market thus does not exert discipline over the transaction. The usual tension between seller and buyer is lacking. It is this absence of market discipline that is most troublesome and creates the potential for abuse.

OTS regulations are designed to counteract this tendency by imposing limits or controls on insiders' activities in connection with mutual-to-stock conversions. OTS conversion regulations, which govern all aspects of the conversion process, set forth specific and detailed standards that have been consistently imposed in conversion transactions over the years. To receive OTS approval, an institution must meet the following conditions: eligible savings account holders have first priority in purchasing stock after any tax-qualified ESOP purchases. Descending priorities then go to remaining account holders, management, and employee stock purchases, local community members, and finally other members of the public.

Purchases by officers and directors in the aggregate are limited to between 25 and 35 percent of the total conversion stock offering, depending on the asset size of the converting institution. Management compensation claims are subject to review and approval by the OTS.

The conversion stock must be sold at a price equal to the estimated pro forma market value of the converting institution's stock based on an independent valuation. Proxy materials to be furnished to account holders must comply with the disclosure requirements of the Federal securities laws and specific OTS thrift disclosure requirements.

The conversion application must include a business plan which describes the institution's intended use of the conversion proceeds.

Mr. Chairman, the nature of mutual-to-stock conversions and the dynamics of the marketplace make it difficult to write regulations in this area. OTS has revised its conversion regulations several times since 1974 and remains open to any suggestions for further improvements.

Despite the complexity of this area, we continue to believe that minimum regulatory standards in the conversion area are desirable to curb the potential for abuse inherent in the skewed economic incentives in mutual-to-stock conversions. If such conversion standards are appropriate for OTS-supervised mutuals, they are presumably appropriate for other mutual institutions that convert.

In your letter of invitation, you asked about the effectiveness of the appraisal process in insuring the conversion stock is priced at a fair market value. Determining the market value of an institution is more of an art than a science. In our experience, the initial appraisals filed with the agency are frequently rejected as too conservative—in other words, too low—an estimate of the fair market value of the converting institution. OTS staff estimate that in recent years approximately three-quarters of all appraisals are initially rejected by the OTS because they are undervalued.

Because a conversion lacks the traditional willing buyer, willing seller tension that generally produces a fair market sales price, the appraisal is critical to achieving this result. The tendency on the part of the appraiser, however, is to undervalue the institution so as to avoid harming the buyers, the party whose interest predominates in the conversion, because they are the only recognizable party in the transaction. The seller, the institution itself, can only be heard through the voices of its management, who are usually buyers of the conversion stock and who retain the appraiser to value the institution.

Due to the nature of these relationships, the role of the regulator in the appraisal process is to exert discipline on the appraiser to estimate more accurately the true value of the institution upon completion of the conversion. Ultimately, the agency must be satisfied that the valuation range for the stock that is established by the appraiser is acceptable.

You also asked, in your letter, that we address the issue of merger conversions. These transactions raise unique issues not involved in other types of conversions, including the adequacy of the consideration paid by an acquirer, the treatment of mutual account holders in the distribution of conversion stock, whether mutual account holders should be able to purchase conversion stock at a discount, and the appropriateness of management compensation arrangements and stock incentive packages offered by an acquirer to coax the mutual management into the conversion.

As a result of these concerns, the OTS recently imposed a moratorium on healthy thrifts entering into these transactions. The moratorium will provide OTS staff with the opportunity to review the merits of merger conversions, including whether additional safeguards are necessary to protect the mutual target's account holders, whether further limits on management compensation and stock arrangements are needed, and the nature and amount of any such limits. The moratorium will not block the acquisition of an undercapitalized thrift by a healthy institution, nor is it intended to interfere with bank acquisitions of stock thrifts.

With respect to the OTS's views on your bill, S. 1801, we are in strong support of the application of consistent standards to all Federal and State mutual-to-stock conversions. We further believe that the specific provisions of S. 1801 related to executive compensation

are worth considering as we review our regulations. In particular, we are reviewing our ability to scale back on the management recognition program, although not to the point where we want to eliminate the incentive for management to enter into conversions.

We defer to the FDIC on the specific question of whether legislation is needed in order for the FDIC to apply specific conversion standards to FDIC-supervised thrifts. We believe that we can apply most of what I think has been mentioned by Chairman Hove and what is in your bill through our current regulatory authority.

In conclusion, mutual-to-stock conversions provide an opportunity for an institution to raise capital. The thrift industry, which is still in a recovery stage, has benefitted from the infusion of capital that has occurred as a result of the conversion process. Conversions may, however, tempt an institution's insiders to engage in transactions that transfer an inappropriate amount of the institution's value to the insiders.

The OTS mutual-to-stock conversion regs reflect standards and safeguards developed over the years to counteract the lack of market discipline in the process and to respond to the potential for abuses in thrift conversions. We believe there is no compelling reason to permit what amounts to regulatory arbitrage that may disadvantage the institution, its depositors, or its local communities. To the extent that standards are necessary to guard against abuses in the conversion process, we believe these standards should be consistent. The issue is not OTS rules versus State rules, but identifying what abuses, if any, exist and applying uniform rules.

Thank you.

The CHAIRMAN. Thank you very much.

I appreciate the detailed nature of your statement. I want to run through a series of questions with each of you and then we will go to Senator D'Amato.

First, Mr. Hove, let me start with you. That is, I am concerned that we are receiving some mixed messages here. Your testimony states that while the FDIC has sufficient authority to curb abuses—and that is a quote—in the conversion process, you say you need additional statutory authority to reform the conversion process along the lines that you have described.

So I have got two specific questions that I want to pose and I want you to respond to for the record.

Does the FDIC possess statutory authority to prevent abuses in conversions, particularly those involving highly capitalized institutions?

Mr. HOVE. We feel we do. However, as you know, our statutory authority is limited to safety and soundness, and we are relying on safety and soundness to review those applications that are coming to us to determine whether they are appropriate.

We also are looking at the guidelines that the OTS has issued, and are looking at institutions to make certain that there are not abuses for insiders. In fact, last week we approved—I am sorry, Tuesday of this week—we approved a merger conversion for an institution that was badly in need of capital.

Now, you are asking about those highly capitalized institutions. We think we do have the authority to restrict the abuses that we

have seen in those highly capitalized institutions with the statutory authority now.

Some of the issues that we have proposed here may require statutory authority to extend those provisions.

The CHAIRMAN. Let me ask you this: Whether or not the system is overhauled entirely, I am wondering, and I need to know your view as to whether your current statutory authority is sufficient to allow the FDIC to adopt the type of specific standards that are currently present in the OTS conversion regulations.

Mr. HOVE. It is our opinion that it is.

The CHAIRMAN. That is an important point.

Let me ask you, then, this as a follow-up to that. The OTS obviously has staff with very great experience in these mutual-to-stock conversions which you made reference to. In fact, going back to the Federal Home Loan Bank Board, the OTS has regulated mutual-to-stock conversions since 1948, and the FDIC has not had a great amount of experience in this area. I am wondering, in view of the priority that the administration as well as this committee has placed on regulatory consolidation, if we shouldn't consider having OTS be made the Federal regulator of mutual-to-stock conversions for both Federal and State institutions. What would you think about that?

Mr. HOVE. It seems to me that the primary regulator that has been dealing with the institution in the process, both in the case of a regular conversion and a merger conversion, is probably in the best position to negotiate the transaction, to look at the appraisals, to make a determination as to the appropriateness of the transaction and the fairness to all parties involved.

I would argue that it makes a lot of sense for the primary regulator, which in this case now is the FDIC, to have this authority over those institutions which we regulate.

The CHAIRMAN. I want to come back to the issue of your response to my second question, and that was that you felt that you did have sufficient statutory authority to adopt specific standards along the lines of what the OTS is doing.

The OTS just imposed a moratorium on merger conversions because they have raised these policy issues, and as you cite, just this week you have approved a merger conversion.

It sounds to me again like we are kind of operating on two different footings here, and I am wondering if there is some way to get to a comparable and unified policy here?

Mr. HOVE. I wouldn't disagree with what Mr. Fiechter has said about his moratoriums, in that he has said that supervisory reasons would be an exception to his moratorium.

I think there are good supervisory reasons, first of all, for why you would have a merger conversion. There are also good reasons for merger conversions—because they have been good transactions. If they are not abusive, it doesn't seem to me that it makes sense to hold them up just because they happen to be a merger conversion. There could well be merger conversions that are not abusive; that are good for consolidation of the industry, and make a lot of sense. So, for that reason, I would argue against a moratorium on all merger conversions.

The CHAIRMAN. Are you holding some up now?

Mr. HOVE. We now have five applications at the FDIC. One we have approved this week. Another one is a merger conversion for a supervisory institution, which, if it makes sense, we will probably approve. There are two others that are standard conversions and one other conversion that involves a mutual holding company.

The CHAIRMAN. Well, let's set aside the first one that is still in the cattle shoot and take the others. Do you think you ought to be proceeding on those until this is nailed down so there are some standards here that we are guiding by in a more specific way?

Mr. HOVE. We intend to look at these very carefully, again to apply the standards that OTS has described, to apply some of those thoughts that we have developed as we have looked at these. Again, let me emphasize that these are preliminary thoughts that we have on these conversions and that we are developing these to improve the process. We will work very carefully and very closely with the OTS to develop these so that we have consistent standards with the OTS.

The CHAIRMAN. I want to make sure that everybody is on notice, including those in the room and representatives in the room of other entities and the people at the press table that the effective date of our legislation is January 26. If this legislation is enacted, with that effective date, anything that is done after that date is subject to review, so that there is no mistake about it. I don't want to rush. I don't want to see a lot of people rush into situations that are questionable without understanding precisely the strength of the feeling here on it.

Let me just ask one other thing before yielding to Senator D'Amato.

The Shadow Financial Regulatory Committee last week proposed that half the proceeds of each mutual-to-stock conversion should go to the FDIC, in particular to the Savings Association Insurance Fund. What is your evaluation of this proposal, Mr. Hove?

Mr. HOVE. Well, it is hard to tell who this value really belongs to. But I would argue that the FDIC or the savings insurance fund or the BIF insurance fund really are not the appropriate places for that money to go. It seems to me that it belongs to someone else rather than to the FDIC. I would argue that it should not be included with the BIF or the SAIF funds.

The CHAIRMAN. Mr. Fiechter, what is your view on that?

Mr. FIECHTER. I agree with Chairman Hove. As you pointed out, Mr. Chairman, initially, I think that the thrift industry, particularly weak institutions, are in much better shape to be able to deal with problems when they are in the stock form rather than mutual form.

The last couple of years we have really had a bull market in the thrift industry. There have been lots of conversions in the mid-1980's, where there is nothing like the kind of excess capital we are talking about right now. It is very likely that we could have conversions a year from now where you are not going to have that large amount of capital or where those institutions several years hence run into trouble, and if we start moving to take capital away from well-capitalized thrifts to build up the SAIF, I think we could regret that several years later.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you very much, Mr. Chairman.

I think you have really touched on the most important areas.

Pursuing the Chairman's line of questioning, Mr. Fiechter, how important do you view the economic incentives for management in stimulating the conversion process, and would the provision in our bill, the 1-year delay, inhibit or stop the conversion process, in your opinion?

Mr. FIECHTER. I think, Senator, that we could scale back the kinds of compensation that have crept into the process the last couple of years, without inhibiting the conversion process from going forward. I really do compliment you all in terms of forcing us to focus on this issue. We didn't have what we call management recognition programs, the benefits going to management at the time of conversion.

They have crept in, in the last 4 or 5 years, and I think that the direction, as I understand the proposal in your bill—which is both to give the new owners of the institution more of a say in what kind of compensation and to design systems that reward good management for staying and doing well going forward as opposed to rewarding management for past years of service—has a lot of merit.

Senator D'AMATO. So you don't see the 1-year waiting period after the conversion before allowing the shareholders to vote on these compensation packages or increases as stopping the process?

Mr. FIECHTER. I don't think that it will. Again, I want to spend some more time on it, but I agree with that objective, but I also agree, as Chairman Riegle said, that we don't want to stop the process. And so, we have got to scale it back without eliminating it. But if we can, in talking with institutions that have previously converted—and I have talked to some thrifts that are mutuals who have said MRP's, in their view, can be eliminated. They don't think that that is critical.

Senator D'AMATO. Mr. Hove, what do you think?

Mr. HOVE. I would agree.

Senator D'AMATO. Let me touch on something that again I know the Chairman is concerned with, since he brought it up and mentioned it with Mr. Hove, mentioned it with you, Mr. Fiechter, given the fact that our legislation was put in on January 26 and there is that provision which would make the provisions effective as of January 26, it seems to me that any conversions that have or will be approved run the risk of having a situation where they may have to be unwound when and if this legislation is passed.

Have you approved any conversion since the 24th? I don't know if you can detail them now, but certainly, get us that information.

Second, is it prudent to proceed with those conversions unless they have addressed the minimums that we have provided in this legislative package? Or do we create just a real tumult, a real problem if indeed—let's just take the area of compensation for the insiders and we find a situation that they have already been rewarded and they have not met the provision we provided?

Would you care to comment on that? It is a convoluted question.

Mr. FIECHTER. No, no. I understand fully. I think clearly the counsel to the institutions that have converted, and there have been institutions that have converted since the bill was introduced, had to look long and hard at this. I am not—and this is an off-the-

cuff response—I am not certain you have to unwrap the deal. I think it may be that the management compensation might have to be unwrapped, but not the deal itself.

Senator D'AMATO. So let me put it another way. All right. Whatever you have done, it's done. We will have to take a look at it or somebody will take a look at it at some point in time. It would seem to me a much more prudent course of action is not to approve conversions that don't basically meet the limitations, the floor limits that we have placed on. You may want to go further, or some State regulator; for example, New York has, at least the superintendent—and I applaud him, I think he did a great job, absolutely great—but they may want to go further. But to at least meet the minimum levels. It doesn't seem to me, Mr. Fiechter, to be prudent.

Care to comment? As I would say, if somebody comes in, he's got this huge economic package, you say, "For God's sake, no, we are not going to approve this because this runs afoul of what the Congress is contemplating putting in. You are either going to have to wait or you're going to have to scale this back to at least meet those minimum standards." Am I wrong?

Mr. FIECHTER. Let me respond in writing for the record as to that.

Senator D'AMATO. What do you think about that?

Mr. FIECHTER. Again, I think that that is a risk that the institution is running. I am not convinced—or that the management of the institution are running—given that there were conversions arguably that were approved the hour that that bill was introduced. There is a very expensive process involved in getting the applications before us. The bill was introduced at a time when we had a slew.

Senator D'AMATO. I am not talking about those three or four that have gone through or whatever. You are going to respond in writing to that.

I am talking about from this point on, those that haven't been put in there, it would seem to me that you would want to say, "Look, in your approval process," and I am not attempting to micromanage your operation, but it doesn't make sense to me to be letting some guy get some, you know, obviously large package of compensation if it flies in the face of what we are indicating here.

Mr. FIECHTER. No. I think I agree on a going forward basis.

Senator D'AMATO. What has happened we will have to try to look at and unravel and see in terms of the law. But I mean, I am saying to you at this point forward, you ought to tell the guy if he says, well, I am going to give the inside people $5 million or $2 million or $10 million or whatever they're going to get, "Wait a second, fellows, we will approve the rest of your plan. It's a perfect plan. But not this. It has to be subject to the stockholders."

It would seem to me that a lawyer, even charging pretty good rates, you go to the best firm over there at 300 bucks an hour or 500 bucks an hour, in about 10 hours could change that part of that package. You know what I am saying? So we are not saying pull out everything; we are talking about specifically this area as it relates to the compensation for the insiders.

I would suggest to you that it seems to me you would be making an error if you are letting this thing go forward, if you let them go forward on that basis.

Mr. FIECHTER. I would like to respond. The difficulty we have is this is an ongoing process, and clearly the Chairman and the Ranking Minority Member of this committee have an awful lot of authority. But as an agency, with a process that we have had for 20 years, if we change the process based on bills that are introduced, and there could be another bill introduced that had a different set of standards, if we change our standards based on every time a bill is introduced with the retroactive, it becomes awfully difficult from an administrative process. And I don't want at all to suggest that I don't give an awful lot of weight to the suggestions that are proposed.

Senator D'AMATO. Let me just, if I might on the Chairman's time.

The CHAIRMAN. Please, go ahead.

Senator D'AMATO. We are not attempting to come in by way of every bill. There are lots of turkey bills.

Mr. FIECHTER. No, no. This bill has a lot of care behind it.

Senator D'AMATO. There are lots of turkey bills, and I have signed on to a few of them. I have authored some of them, sponsored some of them. And they don't go any place.

[Laughter.]

But I have a feeling that this bill, as it relates to the central theme of unjust enrichment, now, that might not be the precise legal term, but, you know, in the real world, for crying out loud, it is really giving people money—just because they happened to be in the position to exercise something—that they really shouldn't be getting.

That is what we trying to deal with here. That is what the commissioner in New York is trying to deal with. I know that is what you are concerned about. So I would say to you, as it relates to that particular area, it seems to me that that should be like this little light, you should say, "Wait, Stop," as it relates to that. It is going to pass.

I don't know what the fellows on the other side are going to do in the House. They will probably go further because we are, you know, we all conservative compared to them.

Mr. FIECHTER. I don't get the sense that they are on a different course than you are on this issue.

Senator D'AMATO. They will come in with a thing that stops it all, gives the money to Mother Theresa, you know.

[Laughter.]

That may not be a bad idea, you know. Rather than FDIC, Mother Theresa gets my vote. You don't believe me? You don't know the process.

All I am saying is that, as it relates to that salary thing, Mr. Fiechter, it seems to me you should be telling them as they come in, and your people should be alerted to it, "Hey, fellows, be sensitive, because there is going to be something like this, maybe another year, maybe in a different form." But, I don't know any Members on this committee who are going to vote against this.

Mr. FIECHTER. We would be delighted to work with the committee staff over the next 4 weeks to try to resolve this and come up with something. I don't think this is something that if we spend 3 years working on, it's a good idea.

Senator D'AMATO. I thank the Chairman, and I thank you, sir.

The CHAIRMAN. Well, and I would hope, too, you guys could operate in tandem. You know, it sounds to me like, we ought not to be going off in different directions. And I like Senator D'Amato's Mother Theresa test, and it's not going to Mother Theresa now. We know that.

[Laughter.]

So let's see if we can't sort of sing off the same piece of music here. That has always been one of the problems in the regulatory process, is that, you know, it gets so arcane that we don't reach practical, sound, workable, achievable sort of common-footing understandings. I think we ought to here. The basis for that has been laid in this discussion, and I think we ought to be putting out essentially the same set of signals.

Mr. FIECHTER. We would love to have a joint rule.

The CHAIRMAN. Let's see if we can't accomplish that.

Mr. HOVE. I agree. We will work very closely with the OTS toward that end.

The CHAIRMAN. And let's try to move ahead on this. I mean, you have a lot of things to do. You were here yesterday on other issues, and I know you have other things in the air. But you are both reasonable men, and this shouldn't take forever to reconcile.

Unless you have additional questions for these witnesses, let me thank you and excuse both of you and call our next panel.

Mr. HOVE. Thank you.

Mr. FIECHTER. Thank you.

The CHAIRMAN. Our panel consists of Mr. Derrick Cephas, superintendent of banks, from the State of New York, who was referred to earlier by Senator D'Amato; Mr. William Drumm, who is the superintendent of the division of savings and loan associations and division of savings banks, from the State of Ohio; Mr. David Carson, who is the chairman, president, and CEO of People's Bank in Bridgeport, Connecticut, and he is here testifying on behalf of the Savings and Community Bankers of America; and then finally, Mr. Chris Lewis, who is the banking and housing policy director for the Consumer Federation of America.

We are pleased to have you all. We will make your full statements a part of the record.

I know you have prepared your statements with care, as you should and as we expect and appreciate. I think you should feel, though, that you can go to the high points of your statement and also feel free to make any additional comments on what you have already heard this morning. So feel as if you can have that degree of latitude.

Mr. Cephas, I think we will start with you, and we would like to have your statement first, and then we will proceed to the others.

OPENING STATEMENT OF DERRICK D. CEPHAS, SUPERINTENDENT OF BANKS, STATE OF NEW YORK, NEW YORK CITY, NY

Mr. CEPHAS. Good morning, Mr. Chairman. Thank you very much.

And good morning, Senator D'Amato.

I appreciate the opportunity to appear here this morning to present the views of the New York State banking department. I prepared a more lengthy statement, which is in the record, but I will summarize here our views.

The issue of conversion of savings institutions from mutual-to-stock form of ownership has commanded the attention of the banking industry for several months now. We in New York have had occasion to review this issue in some depth recently, and in that connection, I would like to include in the record of this hearing a copy of the policy statement which my office issued yesterday.

Finally, before I turn to the substance of my remarks, I would also like to respectfully ask for the committee's understanding of my desire to limit my remarks today to stock conversions in general and not to comment on any particular institution or any particular transaction.

Chairman Riegle's letter confirming my participation set forth several questions which the committee sought to have addressed, and I will answer those questions individually.

The first was: Who owns a mutual institution?

Under New York law, no one owns mutual institutions. That is clearly the answer under New York law, and as far as I am aware of, it is also the law in every other jurisdiction. A New York court as recently as January 1994 affirmed this conclusion.

Neither the depositors nor the management and trustees nor the community actually owns a mutual. Because of this unique status, the responsibility, I believe, falls to bank regulators to protect the public interest in the conversion process.

What parties, if any, should receive priority rights in a conversion? I assume the term "priority rights" refers to rights to subscribe for stock to be issued in a conversion.

In New York, the law provides as follows: Depositors have a priority in the purchase of stock and all public offerings. Depositors vote to approve or disapprove of conversions in all cases except in failing bank situations.

Uncontested sales of control are allowed only in the context of undercapitalized institutions, and contested sales of control are allowed in other contexts in which depositors have a right to vote. In most cases, depositors clearly should receive a priority right to purchase stock.

In an effort to facilitate the conversion of financially weak institutions and to add greater flexibility to the conversion process, we have deviated from this standard in two cases of the sale of control.

To what extent should management and insiders be allowed to participate in a conversion? Should they receive preference over depositors?

As I stated earlier, depositors in New York usually receive a priority to purchase stock in a conversion. To the extent that management and insiders are also depositors, they are entitled to purchase

stock on the same basis as all other depositors. We believe this to be an equitable policy.

With respect to compensation payable to management and insiders as part of the conversion, the banking department has already proposed regulations that would require the compensation arrangements of management and trustees to be reviewed for fairness to the converting institution and its depositors. While management and trustees should be permitted to receive fair and reasonable compensation, including incentive compensation, for their contributions to the institution, the wholesale transfer of material amounts of net worth of converting institutions to management and trustees should not be allowed.

How effective is the current appraisal process in insuring that the stock is priced at a fair market value?

This is a rather complex question and one that is under the active review of the banking department. We believe that the appraisal process warrants significantly closer scrutiny. New York State requires appraisal to be completed pursuant to the OTS guidelines, since we have not issued our own procedures in that regard.

Pending a review of the existing guidelines, we are considering supplementing the OTS guidelines in New York in several ways to beef up the appraisal standards. And in my written testimony I cover three specific areas where we would intend to revise or reform the appraisal guidelines.

Do sufficient standards exist to insure that the conversion proceeds are utilized productively? We believe that the regulatory procedures in this area may well need enhancement. In that connection, we have proposed in our policy statement of February 24, which was issued yesterday, that the boards of trustees of converting institutions adopt a business plan prior to or contemporaneous with the adopting of a plan of conversion.

The business plan has to be filed with the banking department and has to set forth at a minimum, one, the institution's reasons for converting; two, the institution's planned use of conversion proceeds; three, the institution's plans with respect to the payment of dividends and the repurchase of stock in the market; four, the anticipated effect of the conversion on an institution's traditional lines of business and its ability to serve its customers.

The next question: What issues are raised in a merger conversion, and how should such proposals be evaluated?

Merger conversions raise a number of concerns, most of which have already been identified by the committee in the questions discussed earlier.

In a general way, merger conversions raise issues relating to fairness to depositors and preferences and financial benefits received by management and trustees. However, in New York, a merger conversion would still require depositor approval before it can be allowed.

As to our evaluation of S. 1801 and our assessment of the effectiveness of the fairness of the current conversion process, I would like to make a couple of quick observations. As regulators, we are faced with large financial institutions with large capital bases which are owned by no one. Converting from mutual-to-stock form

is a legitimate business objective and has over the years allowed the thrift industry to raise billions of dollars of additional capital. I believe that we all should be supportive of that objective.

The narrow question then arises as to how best to regulate a thrift institution in its transition, as it changes from mutual-to-stock form. The rules and regulations applicable to conversions are, and should be, evolutionary in nature. As markets change and as corporate practices and other circumstances change, the regulatory system should respond to the changing circumstances. That is what we have attempted to do in New York at the regulatory level: revise our conversion regulations in view of present-day business practices and market realities.

As to this committee's proposal to enact S. 1801, let me first say that as a bank regulator, especially as a State bank regulator, we as an institution would always prefer to be given the opportunity to resolve issues at the regulatory level and at the State level.

Having said that, let me also say that I understand and appreciate the concerns which the committee is attempting to address in S. 1801. The issues which the committee has focused on certainly need to be addressed, and the committee has rightfully, I believe, brought public attention to these important matters.

If the committee and the full Senate proceed to enact S. 1801, I would like to respectfully make two observations. I believe that significant flexibility should be maintained at the regulatory level. There are many judgments to be made in the conversion process, and while the Senate certainly has the expertise to make those judgments, the regulatory apparatus is less cumbersome and is able to respond more quickly than legislative bodies in this regard.

Second, as to the proposed Treasury Department study, I would suggest that the committee consider shortening the time period called for in the study from 1 year to 6 months. There is currently a cloud of uncertainty hanging over the entire field of conversions which should be removed as soon as practicable.

While the subject matter of the Treasury study is important, it is also important that the study be completed on an expedited basis so that those banks which are determined to convert can continue to do with a minimum of regulatory uncertainty. The public market for converting thrifts has been exceedingly hospitable in recent times, and no one knows how long it will remain so.

I appreciate the opportunity to appear here today before the committee, and I hope that my comments have been useful to the committee in its deliberations. Thanks very much.

The CHAIRMAN. Thank you very much.

Mr. Drumm, we will go to you next.

OPENING STATEMENT OF WILLIAM J. DRUMM, SUPERINTENDENT, DIVISION OF SAVINGS AND LOAN ASSOCIATIONS AND DIVISION OF SAVINGS BANKS, STATE OF OHIO, COLUMBUS, OH

Mr. DRUMM. Thank you, Mr. Chairman, Senator D'Amato.

I would preface my remarks by seconding those items which Superintendent Cephas just brought to you. I find him to be much more articulate than I am myself in putting those things before you. But I certainly concur with the conservative attitude.

I come this morning wearing two hats, really, in that I am superintendent of the Division of Savings and Loans and Savings Banks in Ohio, but I also happen to be chairman-elect of a small, not too well known organization, which is the American Council of State Savings Supervisors, in short, ACSSS. We are a group of State supervisors who share many, many similar concerns, among which is that of the chartering system.

I was very interested in the comments made by Chairman Hove and Director Fiechter. With a few minor adjustments, I fully endorse those rules proposed by FDIC, and I make no reference to OTS because I thought that would be covered in other persons' comments. Those proposed rules are out for comment until, I believe, mid-March. We do intend, both ACSSS and the separate supervisors of the respective States, to respond. But I think you will find a general concurrence in the position that FDIC is taking.

Their approach, in my opinion, adequately covers the mutual-to-stock issue. There is an excellent working relationship between FDIC and the various State regulatory agencies. I think this is a very significant point. But with the proposed rules and the existing or soon-to-be-adopted State rules, I believe that further legislation isn't necessary at this time.

I feel, too, as Mr. Cephas stated, that you deserve congratulations for bringing to the attention of those of us who are in charge, the issues that you have. I think now we have sufficient tools with which to deal with these issues.

Because conversion is such a complex issue, we have developed model regulations for the various States to adopt. I know that the model that will soon be finished will be welcomed and probably adopted by these respective States. I am talking about 25 or 30 separate States.

For example, my home State of Ohio has rules governing charter conversions, but which we have found are not adequate in today's climate. I brought with me a few copies of our draft of the new, very comprehensive regulations on which we will begin the process of adoption next week, and I would like to leave those copies with you. They were not available yet when my testimony was drafted earlier this week.

I believe that these rules more than meet the weaknesses which are in the current regulations. For example, existing or running proxies, whatever you care to call them, cannot be used in Ohio for any issue having to do with charter or constitutional changes. New proxies must be solicited by the institution, and the solicitation must include a full explanation or disclosure of the purpose for which the proxy request is being made. Where the charter changes are being proposed, there must be a three-fifth's majority of all eligible voters cast in favor of that issue.

Stock subscription rights are offered first in this new Ohio proposal to all eligible depositors before any awards can be made to so-called insiders. I believe this is a stringent but fair set of regulations which, along with those proposed by FDIC, adequately cover all of our concerns without any moratorium or other disruption of an orderly process which allows the marketplace to work.

I would like to insert one other comment here, and it has to do with an answer that came up to either Chairman Hove or Director

Fiechter, having to do with what does an association do that has right today a conversion program in process? We happen to have two in process in Ohio, and the question has been asked of our office, "What do we do?" Our advice to them is: Go ahead with the plan you have in mind, submit it as you normally would, and insert a proviso that if the rules do change, you are going to have to either unwind or alter your conversion plan.

I thank you very much.

The CHAIRMAN. Thank you.

Mr. Carson, we would like to hear from you now.

OPENING STATEMENT OF DAVID E.A. CARSON, CHAIRMAN, PRESIDENT, AND CEO, PEOPLE'S BANK, BRIDGEPORT, CT; TESTIFYING ON BEHALF OF THE SAVINGS AND COMMUNITY BANKERS OF AMERICA

Mr. CARSON. Thank you, Senator Riegle, Senator D'Amato. Thank you for the opportunity you give me to testify today on behalf of the Savings and Community Bankers of America, of which I am vice chairman. I am also chairman and chief executive of People's Bank, which is a $6.4 billion Connecticut-chartered savings bank owned by the country's first mutual holding company, People's Mutual Holdings, which owns 78 percent of it.

I think what we have heard today from the regulators is that they do have the authority to act, and what I would urge is that you examine those authorities because I believe they are even broader than was indicated in their testimony.

For example, the FDIC talks about their authority under safety and soundness, but I can also testify that, as a State-chartered bank, the FDIC is also our securities regulator and, as such, has all the powers that you would normally think would be resident with the SEC in terms of regulating the securities of State-chartered bank.

That, to my mind, is a very extensive power and it is one that is clearly used in the public markets for common stock of all varieties and not just of banks. We believe that that authority clearly allows them to delve into the issues of the purpose of capital at the time it is raised, as the SEC also does in terms of approving the prospectuses for those institutions where it is the primary regulator, as would be the case under OTS of regulated institutions.

In short, the authority is complete. Legislation, for example, on issues having to do with the raising of the capital raises a question of making an already complex system even more complex.

Certain issues which have been raised, such as stock options, miss, I believe, the point. The question isn't when is an option granted, it is when can it be exercised? At the time of raising capital, Wall Street generally prefers to have management have a parallel interest with the potential shareholders, and, therefore, the granting of stock options is perceived as a powerful assist in the marketing of issues of common stock.

The issue that may be more important is how long should those options be held before they can be exercised? So that, again, that addresses the interest of future stockholders, which we also have to be concerned about in the fact that management has a long-term interest in improving the investment of people who put capital in

the organization and not just the short-term flip that may be involved in any initial public offering.

As we have seen, when capital markets are hot, as they are right now, initial public offerings tend to pop. And certainly no bank stock has popped as much as some of the more celebrated IPO's that have been in the market in the last year.

What is really of concern to people who invest for the long term is whether or not management has that interest for the long term. And therefore, the issuance of options, clearly management has a parallel interest in enhancing those values are important. And so I would respectfully request that you review whether the issue isn't when options are granted, but when they can be exercised.

Again, we do not believe that that is a necessity for regulation. We believe that the marketplace puts a strong pressure upon institutions in the public market for management to have a long-term interest that parallels the stockholders'.

Again, I would just like to emphasize, it looks easy to raise capital now in a bull market. We went public in 1988, which was a very difficult time. And the question of selling stock then involved a lot of sales pitches to depositors, to the community, to broader interests, to raise capital for the banking industry. And at that time we were certainly not a troubled institution, but I can tell you that the additional capital that was raised in 1988 was probably the margin that kept us from the great difficulty that many New England institutions have.

And the trouble with legislation is that it tends, many times, to address a need that may be past by the time it is passed. I don't want to predict a bear market. But the issue of this kind of legislation may look attractive in the background of what has happened in the last year and a half, but could be very unattractive at a time when capital is difficult to raise and when there might be broad needs for capital to be raised.

Very quickly on the issue of charter flips, our research by the Community Bankers Association indicates that there have been 144 charter flips by mutual institutions and 42 charter flips that were stock institutions. And in that period of time, as near as we can tell, there are only six institutions that flipped charters as mutuals that subsequently converted to stock. I believe the association would be glad to make that data available to your staff.

As to depositor rights, we take a strong position that depositors have virtually no rights except potentially upon the liquidation of an organization. The banking industry and the insured deposit industry is a highly competitive industry in which depositors regularly change institutions. As a rule of thumb, it is estimated that 15 percent of all depositors in any bank will change their banks within any given year. To imply that they have at any particular point in time a right of ownership begs the reality of institutions that have been around for 150 years and have seen a tremendous flow of people in and out of that institution who are depositors for reasons. Is a depositor, for example, Connecticut requires that escrow accounts earn interest; does the person with a mortgage become a depositor for the purpose of this kind of passing of rights? They may have absolutely no interest in terms of being a depositor

but rather just in having their mortgage and having their taxes paid on a regular basis.

Again, each State has addressed this issue in ways that are best for it. Connecticut's laws regarding mutuals, for example, parallel very closely their organization of nonprofit organizations. The concept of mutual deposit institutions as nonprofits was clearly embedded until the Federal Government decided that they were taxable entities in 1958. And therefore, the basis of law for the long term was based very much upon how you would handle the dissolution of a nonprofit organization in Connecticut, and no clear ownership of individual property, but with the regulator, i.e., the State, the chartering authority, having the right to review what is best in its terms as to what happens. We still believe that that is the best way to determine what, upon dissolution, are those rights.

In general, the rule of thumb has been that in changes like that, that the continuing function that was outlined in the charter is what is important, and the continuing function in mutual savings banks is clearly the providing of services to the community and the ongoing nature of that, that the requirements of that require additional capital to do that, then that is what ought to be preserved, not a very subjective right for a passing-through customer of the institution.

Finally, the idea that upon the issuance of capital, that a portion of the capital of the organization would go to some other organization, we find to be a taking of property. We find it to be particularly chilling upon anyone who is interested in raising capital or in investing in an institution that needs capital.

By what criteria and by what amount would any such amount be ceded to any other organization we feel is of such a complex nature that we think to even imply that that is a good way to proceed is a very chilling effect upon the whole organization of many kinds of nonprofit, if you will, depository institutions. That would include such things as credit unions, on the mutual funds, which today perhaps are the biggest depositories in the country, as well as upon mutual savings banks.

I appreciate the opportunity to appear before you. I believe you have a full copy of our remarks for the record.

The CHAIRMAN. Thank you.

Mr. Lewis, we would be pleased to hear from you. We will make your statement part of the record.

OPENING STATEMENT OF CHRIS LEWIS, BANKING AND HOUSING POLICY DIRECTOR, CONSUMER FEDERATION OF AMERICA, WASHINGTON, DC

Mr. LEWIS. Thank you, Mr. Chairman. The Consumer Federation appreciates the opportunity to testify today on the issue of insider abuse in the conversion of mutual institutions.

As this committee is well aware, insiders have never been all that timid about converting federally insured institutions into personal playpens. It is a recurring theme that shows up in examination reports of regulatory agencies and in the ashes of failed institutions. But we believe that this year's gold medal for chutzpah and greed perhaps ought to be awarded to the current gang of conversion artists at work on the Nation's mutual savings institutions.

CFA, as you know, Mr. Chairman and Senator D'Amato, believes that the committee performed a very valuable and lasting service over the last few years in reforming the regulation of the S&L industry, but today's hearing attests to the fact that some elements of that job are yet to be completed.

One area of abuse, the conversion of mutual institutions into stock companies, was left untouched by these recent reform efforts, and this oversight, however accidental, has turned into a wonderful fur-lined playpen for S&L insiders and Wall Street fast-buck artists. Most, if not all, of this activity is perfectly legal because Congress, State legislatures, and various regulatory agencies have failed to adequately deal with the problem, with some notable exceptions, and have left a mishmash of weak and conflicting rules on the books that have provided a welcome mat for the sharp dealmakers.

The conversion mania has produced windfalls for the management and directors at many of these institutions and has allowed stock companies to seize institutions at bargain basement prices. It has been a wonderful game for the lawyers, the securities firms, and the insiders, and in most, if not all, cases, the depositors, the owners of these mutual companies, get the crumbs. That is, whatever the insiders drop from their overloaded plates. Surely, Mr. Chairman, we believe this is no way to build a financial system.

We identify four principal areas of abuse and concern regarding conversions: one, insiders obtaining control of institutions through conversions; two, unfair and excessive deals offered insiders to induce officers and directors to push for conversions without regard to the best interests of mutual depositors; three, fraudulent low appraisals of institutions involved in the transaction, thereby letting holding companies obtain mutuals at bargain basement prices; and, four, the limitation of meaningful participation of account holders in the transactions.

We believe that the committee needs to look carefully at whether these artificially induced urges are really good public policy or the right way to build a financial system.

As I note in my written statement, we believe that all responsible supervisory parties have been tardy in recognizing the seriousness of this problem and have failed to come up, at this point, with a workable policy that would insure fairness and end the windfall profit games of the insiders.

I would like to note, though, that among Federal regulators, we are very pleased with the leadership that Mr. Fiechter at the OTS has shown; and amongst State regulators, Superintendent Cephas has been unequalled in his pursuit of fair play in this area.

We do believe, though, that the public and the regulatory community need firm statutory guidelines that will control the conversions and prevent windfall profits and give the depositor owners an even break with the insiders. We believe that S. 1801, introduced by yourself and Ranking Member Senator D'Amato, provides an excellent framework for statutory protections and should be passed with dispatch.

We are pleased that the proposed legislation does not veto State conversion laws and allows State legislatures to enact additional protections for their citizens. Thus the hands of regulators like Mr.

Cephas will not be tied, and States will be able to enact laws to deal with specific situations and specific protections in their jurisdictions.

The proposed legislation properly limits the benefits of conversion provided to any officer, director, or employee to those available to the person as depositor. If the insider is not a depositor, he or she may obtain stock under the same terms and amounts that are available to the general public.

We concur, in our written statement, with the remark made by Superintendent Cephas that perhaps the length of the Treasury study should be shortened so that the Congress is in ready receipt of the recommendations that that study solicits.

We believe that the bill could stand to be improved in the area of disclosure and in proxy voting procedure. A principal area of concern for the Consumer Federation is the poor and often misleading disclosure given to mutual depositors of a proposed conversion. Depositors are often misinformed by management about the nature and consequences of a conversion and are too often provided inadequate time and resources to respond to management recommendations for a conversion.

Second, mutual insiders are often able to manipulate the voting on a conversion through the exercise of previously executed general proxies. And we believe that the bill ought to consider including a prohibition on the use of general proxies; that is, that only fresh proxies ought to be able to be used to approve a conversion. We were pleased to learn of Acting Chairman Hove's indication earlier this morning that these are two areas that the FDIC is currently looking into.

Finally, we do not underestimate the difficulties of apportioning the proceeds of a conversion among depositors, but we do believe that the committee should consider that a portion of the windfall should be plowed back into the communities that have built up the net worth of these institutions over the years.

I think, in contrast to Mr. Carson's remarks, we would recommend that the committee look at the recent example of a California institution that converted, Quaker City Mutual Savings, that set aside in the course of its conversion proceeds for a community development corporation.

Now, perhaps these funds, and Mother Theresa may not be the best recipient, but we would suggest, as we do in our written statement, that some of the excess net worth perhaps could be allocated to the affordable housing program at the Federal Home Loan Bank, which has been a public works asset of the savings and loan industry as a result of your efforts, Mr. Chairman, in the 1989 FIRREA legislation. And all mutual converting institutions are members of that system. That would seem to be a very appropriate repository for any excess net worth.

In conclusion, while the conversion issue may not be the biggest regulatory problem to come before this committee, it is clearly a prime example, an exhibit for those pushing for rational consolidation and coordination of regulatory policy and enforcement. And, Mr. Chairman, you know that we are very supportive of your efforts in that direction.

We believe that the Congress needs to clean up this mess now while there are some mutuals left to serve local communities. The conversion game has been going on full tilt, and if remedial action is delayed, the issue will be relegated to the graveyard of good ideas that Congress let die on the vine.

The funds clearly are not going to Mother Theresa now, and for the depositor owners who are ripped off while the insiders trot off to the islands with the goods, next year will be too late.

Thank you, and I would be glad to respond to any questions.

The CHAIRMAN. Thank you very much.

Let me thank all of you.

Mr. Drumm, let me start with you, if I may. You state in your testimony that many of the news articles concerning the merger conversion of Heritage Savings Bank into Provident Bank Corp. have been erroneous. And I think now would be a good time then to correct the record as you see it.

The American Banker, which usually tries to pin these things down with some care, has estimated in their reporting on this that Provident would be paying about $1.6 million to officers and depositors of Heritage even though Heritage had an appraised value of nearly $5.7 million. Now, is that right? What is accurate here?

Mr. DRUMM. This has been a difficult one to follow on a dollar-for-dollar basis. I have brought with me a breakdown, as near as we have it at this moment.

Their approval is still a tentative one. It has not reached final approval. As a matter of fact, both FDIC and our staff are on the premises as we speak, reviewing the entire process that they have gone through.

I have brought with me a copy of the deal, as we knew it when the preliminary approval was given. I will be glad to furnish that to you.

Because there is an ongoing review of those details, I would prefer not to discuss them openly at this point. I will provide you all the information that we do receive.

The CHAIRMAN. I do not want to get into all the details, and I am very much interested, and I would not want you to sidestep the issue as to whether in rough orders of magnitude there are these kinds of differences between the actual appraised value and then the value that has been established in terms of this transfer. I mean is there a gap of that magnitude here?

Mr. DRUMM. No, I don't believe so.

The CHAIRMAN. Is there any gap at all?

Mr. DRUMM. There is a gap that was filled by the Provident Holding Company who, by virtue of their agreement, purchased whatever stock had not been subscribed to or for in the offering.

The CHAIRMAN. I have had some indication that the appraised value, may, in fact, be low, maybe above $5.7 million.

Mr. DRUMM. Our figures don't indicate that. If it's off, it's not very far off.

The CHAIRMAN. I take it, then, that this one is now under review? In other words, this is not on a fast track to just get the stamp of approval; that you are going back and scrubbing this down again. Is that correct?

Mr. DRUMM. Right.

The CHAIRMAN. And the FDIC is in doing it as well?

Mr. DRUMM. Exactly.

The CHAIRMAN. Have they expressed a concern to you about it?

Mr. DRUMM. As recently as yesterday I had a discussion with our people.

The CHAIRMAN. Initiated by the FDIC?

Mr. DRUMM. Oh, jointly, I would say. They are both in there working on the transaction together.

The CHAIRMAN. Are you familiar with this American Banker story?

Mr. DRUMM. Yes.

The CHAIRMAN. Does it contain any major inaccuracy that needs to be cleared up here now? I mean, I am going to put it in the record, and I want to understand whether it is essentially accurate or inaccurate, and you are the person probably in the best position to say here.

Mr. DRUMM. I would prefer to provide you with the accurate numbers that came from them. I don't happen to have them well enough in mind now.

The CHAIRMAN. All right. That is fair enough. I mean, I would not necessarily expect that you would have. But because this issue has gotten this kind of a profile, you know, it is obviously one that you are familiar with and it is one that is not being treated in a run-of-the-mill fashion. And you were talking to the FDIC about it as recently as yesterday, you say?

Mr. DRUMM. Yes.

The CHAIRMAN. But I think the case facts in the American Banker story raise enough serious questions that if this story is essentially correct, we need to have more illumination from you. Now, if it is not correct and you want to challenge the story, I am asking you to do that in some detail. I mean, I do not want this to just slide on by.

Mr. DRUMM. One of the things that has come from, in great part, that experience with the Provident/Heritage deal is the new, very stringent regulations that we are about to put in effect.

The CHAIRMAN. The new ones that are about to go into effect, will they apply to this transaction?

Mr. DRUMM. Yes, to whatever extent we can, certainly.

The CHAIRMAN. But, I mean, putting in new rules, you are not going to have a situation where a certain number that have been standing in line come through under the old process as opposed to the new rules?

Mr. DRUMM. We haven't had that many transactions, in the first place. This is the only, what I call non-freestanding charter flip that we have had in Ohio.

The CHAIRMAN. Will the new rules apply to this deal?

Mr. DRUMM. I can't speak to that, but to whatever extent we can make them apply, yes, it will.

The CHAIRMAN. You haven't made a decision yet, have you?

Mr. DRUMM. Not final, no.

The CHAIRMAN. As long as you are changing the rules, wouldn't it be a good idea to not make the decision until you have the new rules in place?

Mr. DRUMM. Well, that would be my assumption, not being an attorney.

The CHAIRMAN. No, no. And I am not an attorney either. But this is a problem that we are looking at, and if there is a need for tighter rules and you are about to adopt tighter rules and you have a live case, it seems to me, you know, rather than have the live case come on through under the old rules, that it ought to come in under the new rules. Is there some other logic that I am missing here?

Mr. DRUMM. No, I think you are correct.

The other thing that I think should be mentioned is that the people who are involved in both Provident and Heritage are of a mind that they want to do what is right according to the rules, that this is not a rewarding factor for the insiders that have been referred to.

The CHAIRMAN. Well, we are interested, obviously, and I take some measure of comfort from the notion that you yourself feel that the new rules ought to be what applies in this case and in cases like this. You are nodding in the affirmative. Is that a fair observation?

Mr. DRUMM. I am also reminding myself to get copies of this data to you.

The CHAIRMAN. All right. Very good. Thank you.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Superintendent Cephas, let me say again for the record I applaud you for the manner in which you moved.

Mr. CEPHAS. Thank you.

Senator D'AMATO. You moved with speed and alacrity as it relates to the Green Point Savings Bank. Would you tell us what transpired, why you took the steps you did, and what is the eventual outcome?

Mr. CEPHAS. Senator, yes, I will give you a brief background on what happened. We ended up conducting an investigation of Green Point, focusing on four areas, really: the fiduciary duties, whether or not the trustees had met their fiduciary duties; the validity of the appraisal; the fairness of the proxy solicitation process; and the appropriateness of the compensation.

The result of the investigation was that most of the compensation that went to the current trustees—well, all of the compensation that went to the current trustees was entirely cancelled, and a good deal of the compensation that went to the current management was cancelled.

Senator D'AMATO. How much was that, approximately?

Mr. CEPHAS. Well, different people valued it differently. We put a figure of about $40 million on it.

Senator D'AMATO. $40 million?

Mr. CEPHAS. Right.

Senator D'AMATO. In compensation?

Mr. CEPHAS. Right.

Senator D'AMATO. How many people in management?

Mr. CEPHAS. That was about 15 people.

Senator D'AMATO. Fifteen people were dividing $40 million?

Mr. CEPHAS. Those are rough numbers, but that is fairly accurate.

Senator D'AMATO. If I wasn't so nice, I would say "whacking up." [Laughter.]

OK. I just want to get a little perspective on this. Go ahead.

The CHAIRMAN. May I just ask? I assume they were not all getting equal shares. Were some getting more than others?

Mr. CEPHAS. That's correct.

The CHAIRMAN. So some people were getting a big chunk of the $40 million and some a lesser chunk.

Mr. CEPHAS. It was based on, roughly, two factors: years of service; and hierarchy, how high up you were in the organization.

The CHAIRMAN. So the person at the highest point on the pecking order would have gotten what part of the $40 million, roughly?

Mr. CEPHAS. Well, again, it depended upon whether—there were several different benefit packages. One was the RRP, which we just cancelled altogether in New York. The other was the stock options.

The CHAIRMAN. But the biggest slice of the pie would have been how many millions, as nearly as you can estimate it? Rough numbers; we are not looking for exact numbers.

Mr. CEPHAS. Well, the RRP, the largest RRP, was $2 million, which is the stock grant.

The CHAIRMAN. Right.

Mr. CEPHAS. And then, depending on the options, how you valued them and when they were exercised, that was at least that much more.

The CHAIRMAN. All right. Thank you.

Thank you, Senator.

Senator D'AMATO. Oh, sure.

Mr. CEPHAS. So, the end result was that the conversion went ahead, was approved by the State of New York after significantly reducing the compensation.

Senator D'AMATO. About what was that package? It went from $40 million to how much?

Mr. CEPHAS. Oh, the $40 million was entirely reduced, it was eliminated.

Senator D'AMATO. The whole $40 million?

Mr. CEPHAS. The $40 million was eliminated. That is the figure that was entirely eliminated.

Senator D'AMATO. OK.

Mr. CEPHAS. And then with some of the management—that is, people who worked on a daily basis at the bank as opposed to outside trustees—some of theirs was much more scaled down, but some of their benefits remained in place. Then we took other remedial actions going forward; for example, requiring the board to add three additional directors to the new board.

Senator D'AMATO. Outside directors?

Mr. CEPHAS. Outside directors, going forward.

So that is in summary the result of the Green Point case.

Senator D'AMATO. Now let me ask you, the $40 million, how much were they going to raise? How much in new capital?

Mr. CEPHAS. About $800 million.

Senator D'AMATO. $800 million.

Mr. CEPHAS. Right.

The CHAIRMAN. Would you yield just for one more question at this point?

Senator D'AMATO. Certainly.

The CHAIRMAN. Am I correct in understanding that the inside executive who was going to get the largest slice of this had been there all of 6 months?

Mr. CEPHAS. He came in August 1, 1993, and the conversion was filed with us soon thereafter, and it would have closed, had it closed originally, sometime in December. They mailed their proxy materials November 4. So you are looking at a period of August 1 to, say, for example, to November 4.

The CHAIRMAN. Boy, that's a pretty short haul, to walk away with the biggest piece of this.

Thank you.

Senator D'AMATO. Let me ask you, what comments do you have as it relates to the proposed legislation; how could it be improved? Should we have legislation, or should we give to the regulators expanded authority, or do you think they need that expanded authority to deal with this issue?

Mr. CEPHAS. Senator, you know, as I said earlier in my testimony, I appreciate, and I quite frankly agree with the thrust of what your committee is trying to do in S. 1801, and I applaud that as a regulator and as a State regulator.

I do think that the regulatory side ought to be given an opportunity to try to resolve these issues ourselves. And given the public attention that has been focused on this, I think that we have heard some very positive and useful testimony earlier from the Federal regulators, and I think the State regulators also are on board. So my own view is that if the regulatory apparatus can resolve this, then I think an opportunity ought to be given.

Senator D'AMATO. Yes. So, by the filing of the legislation, hopefully we will be able to get some regulatory remedies which will not necessitate us going forth.

Mr. Carson, what is your biggest concern? I mean, obviously we are interested not in attempting to impede, for example, take the Green Point situation, you have $800 million capital there that wouldn't have been there that is there. That is obviously good for the Nation and the local community. And I certainly don't want to impede that. Green Point serves a lot of my constituents, and so now a lot of my constituents are stockholders, and I am happy about that.

How do we deal with the other situation, let's call it for lack of a more precise term, unjust enrichment, you know? And I would say that if a new officer came in and filed this plan as chief executive, he's going to walk away with $4 million or $5 million or $6 million, that potential is the kind of thing that most people would say is wrong. But how do we deal with that? Do we wait for the regulators? Should the regulators—let me ask you this—should the regulators deal with that?

Mr. CARSON. My belief is that the process requires regulation.

Senator D'AMATO. Yes.

Mr. CARSON. The question is: Do the State regulators have that authority? And I think Superintendent Cephas has clearly indicated that they have that.

The requirements of a public disclosure, the proxy statements, the offering circulars, the process by which those are approved, put a board at great risk if they are not, first of all, factually correct.

But, second of all, if they enunciate plans which are against the perceived public interest, they are out there for the public to see. And that is what happened at Green Point. Nobody was shy about picking those up and saying, "This is crazy." Then the question was: Could you do something about it? The answer was: You could.

In our process, to a great extent, in all of securities regulation, whether it's a conversion of a mutual, whether it's an IPO, or whether it is the adding of additional capital, puts tremendous responsibility upon the board of an organization to fully disclose, publicly disclose, and make available the information for which they are raising funds from the public.

Senator D'AMATO. And their compensation packages?

Mr. CARSON. And their compensation packages. You know, I have to disclose probably as much about compensation as anybody. I mean, that is there, and if there are objections to it, believe me, you hear about it. And, you know, I think all of that disclosure had led to a variety of reactions.

Senator D'AMATO. But your hope would be that possibly the regulators on the Federal level look at this issue and come out with clear, definitive rules as it relates to the area of compensation?

Mr. CARSON. I think rules on compensation are extremely difficult. I think guidelines——

Senator D'AMATO. Guidelines. All right.

Mr. CARSON. I mean, there is a big difference between running a $50 million institution and a $50 billion one. Guidelines are very difficult when you are dealing in a highly competitive market for good talent. And, you know, I think the number of people who are fully trained and knowledgeable in running through the complexity of modern banking legislation and regulation and being able to run an organization profitably is limited.

Senator D'AMATO. But here you have a regulator who had the authority to step in and exercise that authority. The question is: Do we have on the Federal level, do our regulators really have that authority, and are they given guidelines sufficient for them to come in when they have to?

The CHAIRMAN. And do they have the gumption?

Mr. CARSON. Yes. Right. I think it is a very chilling effect to say that a regulator is going to set the compensation for anybody. I think that gets beyond where——

Senator D'AMATO. Well, I would yield to you the point that if they set compensation as opposed to having appropriate guidelines, some guidelines within which to measure. Look, clearly in the case of Green Point, as the superintendent has pointed out, you had some people who were acting like pigs.

Mr. CARSON. You pass legislation. You pass legislation which gives the regulators the authority to review compensation.

Senator D'AMATO. No, I am trying to give you——

The CHAIRMAN. We are trying to help you. Aren't you offended by what happened there in that case, the $40 million? Doesn't that offend you as a professional in the field?

Mr. CARSON. I was very happy that the commissioner stepped in and resolved that situation.

The CHAIRMAN. All right. Why? Why were you happy?

Mr. CARSON. Because I agree with you.

The CHAIRMAN. It was offensive, was it not?

Mr. CARSON. I was looking for an explanation about why that was.

The CHAIRMAN. It would help you if you would come right out and say that. I mean, if there isn't some evidence of discernment of the kind of abuse that is taking place here and some sense about it and differentiating between these things, you end up not having much of a case for the very point you are making, if I may say so.

Mr. CARSON. I think the reason why I don't want to immediately jump in, the issue of stock options, I have no idea—the valuation of stock options is arcane, and it has no direct immediate value. If those options weren't exercisable for 3 years, they don't have any value for 3 years and their value is going to be determined not by an arbitrary formula, but they are going to be determined by the marketplace, how well Green Point actually does, what actually happens to it. It is in a highly competitive, very difficult marketplace, as Senator D'Amato knows.

The requirements of securities regulation now require that you take some arbitrary method, tell the public what that arbitrary method is, and put a value on it. But no matter how you cut it, it's arbitrary. None of the methods bears any relationship to any actual individual case.

And Green Point Savings Bank is, again, a competitive market, a difficult market, one in which I don't have any idea whether Green Point stock will sell at half its current value 3 years from now or twice its current value. And neither does anyone. I mean, you are dealing with supposed values, and I think that has got to be clear.

On options, granted, a totally different matter. What is the current compensation package? I could say, "That's ridiculous. You don't need to do that on a conversion." And I would say that. And I am glad that the commissioner acted on that. That would not be allowed under Connecticut law under its conversion regulations. I mean, I find it strange that someone would even think it was allowed in New York.

The CHAIRMAN. Well, it is helpful that you said that, and I thank you for the comment.

Senator D'AMATO. Mr. Chairman, I have no further questions. I want to thank the witnesses.

The CHAIRMAN. Mr. Cephas, it is interesting to me that on the Green Point case, your office imposed more stringent restrictions on management and insiders than the bill that Senator D'Amato and I have drafted. And I am wondering if you think that the restrictions that you used are ones that ought to be applied to all mutual-to-stock conversions.

Mr. CEPHAS. The result in the Green Point case really was specific to that particular situation. At the end of our investigation, we made a series of findings which warranted particular imposition of the remedies that we had in that case. That should not be viewed as a model that we would do going forward in New York.

We put out yesterday, Senator, which I am sure you haven't had a chance to look at yet, a broad, comprehensive policy statement addressing conversions going forward in New York—compensation, the appraisal, solicitation of proxies, fairness of disclosure—addressing a whole host of issues. And I think that policy statement really speaks to what New York's position is going forward; not so much the Green Point result, because that was a particular set of circumstances.

The CHAIRMAN. Now let me ask you, in the Green Point deal you also questioned the appraisal submitted as part of the conversion. How does your office go about insuring that an appraisal is accurate?

Mr. CEPHAS. We have a staff that reviews them, and we use the guidelines that are promulgated by the OTS. We have come to believe that those guidelines may need to be supplemented. And the recommendations in the document that we released yesterday are three items, three ways that the OTS guidelines might be supplemented in order to bring greater comfort to the appraisal process.

It is a complicated process, and there is in all of these appraisals no exact, specific, or pro forma fair market value. But we came to believe that in going forward we could do a better job and the appraisers could do a better job or come closer to the number that more approximated what the stock was actually worth after the conversion. So we focused on that, and we have made a set of three recommendations.

The CHAIRMAN. We will look at that. Good. Thank you. And you have given us, I assume, a copy of it?

Mr. CEPHAS. Yes.

The CHAIRMAN. This was put out yesterday.

Mr. Carson, let me come back to you, if I may. In your testimony you state that you and the Savings and Community Bankers of America are pleased that the FDIC's interim rule will, and I quote you here, essentially track "the regulations of the Office of Thrift Supervision." I am wondering if you would advocate that the FDIC adopt measurable standards in areas such as benefits to insiders as the OTS has done in its conversion regulation.

Mr. CARSON. I think the OTS regulations are a good guideline, and I think put in a context of guidelines, they should be considered as part of the regulations that the FDIC would adopt.

The CHAIRMAN. Would you agree with that, Mr. Drumm?

Mr. DRUMM. Yes, I would, very much.

The CHAIRMAN. Mr. Lewis, I assume you would as well?

Mr. LEWIS. Yes.

The CHAIRMAN. Mr. Cephas?

Mr. CEPHAS. Yes.

The CHAIRMAN. Very good.

Gentlemen, we may have some additional questions for the record. I appreciate your coming today and your testimony and the quality of your presentations.

The committee stands in recess.

[Whereupon, at 12 noon, the committee was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF ANDREW C. HOVE

ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Good morning, Chairman Riegle and Members of the committee. On behalf of the Federal Deposit Insurance Corporation ("FDIC"), I appreciate this opportunity to testify regarding institutions that convert from mutual-to-stock form. I believe there are important and difficult issues that need to be addressed with respect to conversions. Chairman Riegle articulated a number of these issues in his letter inviting me to testify today. Currently, the FDIC has an internal task force reviewing the entire conversion process, whose members are conferring with staff at the Office of Thrift Supervision ("OTS"). We also have an interim regulation in place and have solicited comments from the public on both the interim regulation and a proposed policy statement on the subject. I hope the committee will, therefore, understand if I characterize today's comments as a "rough draft" and reserve the right to modify our views as we better understand this long-studied and complex subject.

Our interim regulation should permit the FDIC to halt the abusive practices that have recently plagued the conversion process and to protect more fully the interests of depositors in a converting institution. However, we have to do more than simply curb abuses in the current process; we need to reexamine the process generally to determine whether it should be redesigned and, if so, how best to achieve that result.

Our testimony will make a number of observations about mutual conversions and in the process respond to the questions in Chairman Riegle's letter. I will then summarize our preliminary thinking about how conversions ought to work and briefly comment on S. 1801.

THE QUESTION OF "OWNERSHIP"

As we read the history, mutual institutions originally had two purposes: to give ordinary citizens access to credit and a safe place for their deposits. With that in mind, it is hard to say whether depositors "own" mutuals, or the whole community does, or no one does.

Under OTS rules and most State laws, depositors are usually given preference to any value in the institution. Some have argued, in the alternative, that the value of the institution should go to the community, or to the Government, or to the deposit insurance funds which suffered losses when mutuals failed—on the basis that depositors did not contract for that value, and do not deserve it. There is some merit to these arguments.

On the other hand, depositors do have rights to participate in a conversion. The fact that being a depositor is not identical to being a stockholder does not alter that. Nor does the fact that, years ago, and many years *after* most of these institutions were founded, the Federal Government took the risk out of being a small depositor by creating the FDIC. Depositors' rights depend on the laws of the jurisdiction in question, so we are reluctant to generalize. However, the FDIC would be opposed to abrogating those rights, except where safety and soundness considerations come into play. We are particularly concerned where those rights have significant financial value—as is the case when healthy, well-capitalized mutuals convert—even if the financial benefit of doing so flowed to one of the insurance funds.

The existing conversion process can be characterized as a compromise: yes, depositors get an opportunity to own the institution, but they have to pay for it. And insiders, who as a practical matter control whether the institution converts or not, have been permitted to stand at the head of the line. As I will explain later, there are major flaws to the existing conversion process as it operates when the institutions in question are healthy. The economic value of the converting institution flows to those who are wealthy enough, and knowledgeable enough, to stand in line to buy it. The process may need to be redesigned, so that the economic value can be distributed directly to those who should get it. But who should receive its value is ultimately a legal and political question for legislators. I admit to a natural bias in favor of depositors. Under our preliminary thoughts on redesigning the conversion process, the Government will get a meaningful share through taxation. In addition, we encourage some voluntary transfer of value from depositors to the community that the bank serves. There is no valid argument that management owns any of the value of a mutual—although as outlined below, there is good reason to encourage some management ownership post-conversion. I would also point out that, as matters stand, management can deny that value to others unless management gets some consideration in the process.

PARTICIPATION IN CONVERSIONS

In our experience, conversion is often a very good idea for the institution in question. It allows weak institutions to recapitalize. It allows institutions to participate in the consolidation occurring in the bank and thrift industries. The FDIC would be opposed to legislation which prevented or discouraged boards of mutual organizations from pursuing conversion, whether of the stand-alone variety or through merger with another institution.

Banks and thrifts benefit when their officers and directors have a stake in the success of the enterprise. It is appropriate that they become stockholders when mutual institutions convert. However, any awards of stock—or of options or cash—should be viewed as compensation rather than an entitlement as if officers and directors were super depositors. Compensation should not be excessive. The term excessive should not be defined too precisely, as doing so tends to create a safe harbor for new, previously unimagined abuses. While giving insiders preference in subscribing for stock does not necessarily produce excessive compensation, it is an imprecise and trouble-prone way to pay senior officers, particularly as the award of options and preferential purchase rights has often represented a thinly veiled means of transferring significant immediate value to the individuals in question. We would also observe that performance-based compensation should be forward-looking; awards should vest over time, and rewards for years of loyal service at the time of a conversion should be modest.

APPRAISALS

Appraisals done in connection with conversions tend to be low. A recognized authority on the subject calculates that in 1993, share prices of converting institutions (both State and Federal) increased by an average of 29 percent in the first month following the transaction. Much of this increase typically occurred immediately. While it is true that initial public offerings are normally priced so as to trade up in the aftermarket, an immediate increase of this magnitude seems unnecessary and inappropriate. There are some obvious reasons why appraisals tend to be low: it makes the underwriters' jobs easier, and it makes those who are able to buy stock richer. Where management is granted options to buy stock at the conversion price, they have a financial incentive to make that price as low as possible. We are informed that some professional appraisal firms market themselves to managements by promising to provide the lowest appraisal regulators will approve. As I will explain shortly, however, the real culprit producing those immediate price increases is not low appraisals but the mechanics and arithmetic of the conversion process itself.

USE OF PROCEEDS

The mechanics and arithmetic of the conversion process also tend to result in institutions raising very large amounts of new capital. While this has been of enormous benefit to the insurance funds in many cases, we note that in other cases institutions have raised more capital than they needed. In some cases, this has led to failures, and losses to the insurance funds, as managements have felt pressure to leverage that capital and improve the return on equity for their new and demanding stockholders. We are concerned about this phenomenon. Reviewing and approving business plans of converting institutions helps in some cases; however, continued close supervision after the conversion is necessary to safeguard against the possibility of excessive proceeds being used imprudently. Banks which grow faster than their peers run the risk of acquiring higher-risk assets. They sometimes make loans other banks will not, either inside or out of their natural trade territory, and in industries they do not understand. They sometimes put money into real estate ventures, taking too much of the downside risk. Their eagerness can undermine credit standards in the market as a whole. Our experience in the 1980's tells us this could be a significant problem.

NUMERICAL EXAMPLES

I would like to provide the committee with a few numerical examples to illustrate the points made in the previous paragraphs, and to demonstrate how the use of stock purchase rights might solve certain problems.

The following examples, for ease of comparison, make reference to market values as a percentage of the book value of the institution. In fact, appraisals performed in connection with conversion transactions typically determine the estimated market value of the institution by considering a number of factors, including book value, earnings, and assets.

The mechanics and arithmetic of the existing conversion process work *fairly* well when the institutions in question are thinly capitalized and/or the market is skittish

about the industry in general—exactly the conditions which prevailed a few years ago, although no longer the case now.

Consider a hypothetical example of a mutual savings bank with $30 million of equity and a leverage ratio of 3 percent. The market thinks the institution may fail. If this institution had stock, the stock would trade far below book value. In order to stave off disaster, the institution's board of directors decides to convert. The board of directors wants a leverage ratio of at least 6 percent, so they set out to raise $30 million: 1.5 million shares at $20 per share. Book value per share will be $60 million divided by 1.5 million shares or $40, but because of the institution's weak earnings, and the taint the thrift industry is under, the appraisal estimates the stock will trade at only 50 percent of book—or $30 million. Since that is exactly what the new stockholders will pay for the stock, the transaction is "fair." The appraisal firm, of course, may be a little cautious. Suppose, as it turns out in this example, the stock trades at 55 percent of book value—or $22 per share. Those who bought stock—and the underwriters had to sell most of it because depositors subscribed for very little—enjoyed an immediate 10 percent increase in value of their stock. In this situation, the existing conversion process has worked reasonably well.

Now consider a second hypothetical example: an excellent mutual savings bank with $100 million of capital that wishes to convert. The institution already has an 8 percent leverage ratio and a much higher risk-based capital ratio, and earns $15 million a year. If this institution had stock, the stock would trade at book value. If the institution simply printed up 5 million stock certificates and distributed them to its depositors in the mail, a market would emerge—at $20 per share.

The existing conversion process does not permit our hypothetical mutual to do this, however, and it would not be an effective way to introduce the institution to the capital markets. An offering of new stock is required. Since the mutual is already well-capitalized, and is cautious about expanding too rapidly, it decides to sell only $20 million of new stock. The institution instructs its lawyers to prepare for an offering of one million shares, and as required by the conversion process, it hires an appraisal firm to certify that $20 per share is a fair price.

The problem is that the one million shares to be sold will give the buyers ownership not only of the $20 million of cash they will pay for the shares, but also of the $100 million of economic value the thrift had before it converted. The one million shares would therefore trade in the aftermarket at roughly $120 each, so then perhaps the shares should be priced higher, say at $100 apiece.

The problem with pricing the shares at this value is that since the thrift only wants to raise $20 million, a price of $100 per share means it will sell 200,000 shares. Since those shares will have a claim on the same $20 million of cash plus $100 million of value, they will trade in the aftermarket at $600 apiece!

The only way, in this situation, to bring the offering price into line with the probable aftermarket price, is to increase the amount of capital to be raised. For example, if the hypothetical thrift stayed with the plan to sell one million shares, but increased the offering price to $100 per share—raising five times as much new capital as it wanted to—those new shareholders would be given a claim on $100 million of cash and $100 million of pre-existing economic value. The institution would have a leverage ratio of 16 percent. Since it would be difficult for the thrift to prudently employ that capital within the next few years, the aftermarket price of the stock would probably fall below book value. If, for argument's sake, the stock price fell to 80 percent of book value, or $160 per share, there would still be a large gap between the offering price of $160 per share and the "fair market value."

In this example, the gap could be completely eliminated by increasing the amount of money raised to $220 million. The arithmetic works as follows. The market values the thrift as it is at $100 million. It values "usable" new capital of $20 million at $20 million. It values capital that will be difficult to deploy quickly at 50 percent of book value—since it will be invested in Government bonds for a considerable period and earn less than half of the required rate of return on thrift equity. In the previous paragraph, that produced an aggregate market value of $160 million: $100 million, plus $20 million plus 50 percent of the hard-to-deploy $80 million. If the amount of capital raised is increased to $220 million, and the amount of hard-to-deploy capital is therefore increased to $200 million, the thrift will have an aftermarket value of $100 million, plus $20 million, plus 50 percent of $200 million, or a total of $220 million—exactly the amount the shareholders had paid for the stock.

Needless to say, this is an inefficient use of capital, and it might be that depositors and other prospective investors would not be willing to provide $220 million of new money. In that case it would be *impossible* to bring offering price and aftermarket price into line.

It is certainly true that appraisals deserve scrutiny, that some insiders have abused their positions, and that some institutions have raised more capital than they could prudently employ. However, the fundamental problem is the "windfall" the existing process itself creates when the institution and the industry are *not* in extremis.

USE OF STOCK PURCHASE RIGHTS

Distribution of stock purchase rights would give those rights the value of that windfall, and allow the amount and pricing of new stock sold to be both sensible and fair. In our hypothetical example of the healthy thrift that wanted to sell $20 million of new stock, the intrinsic value of the right to purchase at $20 per share each of the one million shares to be sold is $100—assuming the share will trade in the aftermarket at $120 apiece.

As a practical matter, the rights themselves might trade at more or less than $100, because there would be uncertainty about where the market would value the stock. If most depositors wanted to sell their rights immediately, the rights could change hands well below $100. This problem could be alleviated if management arranged to have an underwriting group, or a dealer/manager, exercise rights and sell stock on behalf of depositors who did not wish to invest. Depositors might get two different forms in the mail. Send in the pink one, plus $20, and they get back a stock certificate. Send in the blue one and they get back whatever the shares sell for in the public offering, less the $20 going into the institution. How much depositors, in fact, received for their rights would depend on how good a job management did in presenting the institution to prospective investors and in negotiating with the underwriters.

To reiterate a point made earlier, if legislators or the directors of the converting institution believe someone other than depositors should get some of the windfall, they can transfer that value to those other parties by issuing them some of the rights. This revised conversion process works the same, no matter who is considered to own the institution.

MERGER CONVERSIONS

Merger conversions are situations where a mutual thrift in essence is directly acquired by a stock organization. These are the lineal descendants of "supervisory conversions"—which were essentially unassisted resolutions, and made a lot of sense. A healthy bank or thrift absorbed a failing institution, by regulatory fiat, and sold stock to support the increase in its balance sheet and risk profile. Since there was no economic value to the acquired mutual, depositor approval was not required. Merger conversions were conceived as appropriate where the mutual was in danger but had not yet failed. While an appraisal was performed, its purpose was to demonstrate how little value there was.

In a merger conversion of a healthy mutual, on the other hand, an acquiror sells stock at market value and gets the converting institution for free. Depositors of the acquired thrift get preference in subscribing for the stock, but unless they are offered a discount, that preference has no economic value; if the acquisition is positive for the acquiror the immediate increase in price occurs on announcement, not after the stock offering is priced. Where depositors do get a discount, there is still the problem that few benefit, because they lack the cash or risk appetite to buy. History shows that merger conversions have often involved substantial benefits for insiders at the converting institution—often in the form of rich compensation packages.

This analysis does not lead us to the conclusion, however, that other financial institutions should be taken out of the equation by prohibiting merger conversions completely. It only means that the structure of merger conversions has to be changed along with that of standard conversions.

REFORMING THE PROCESS: PRELIMINARY THOUGHTS

As I mentioned at the beginning of my testimony, the FDIC has several efforts underway with respect to mutual-to-stock conversions. First, we are reviewing conversion applications under our new interim regulation to determine whether to object to a transaction for safety and soundness reasons, violations of law or breaches of fiduciary duty. This process involves a case-by-case determination based upon the facts of each proposed conversion transaction. The current standards used in the FDIC's review of proposed conversions under our new interim rule will not necessarily be affected by the potential long-term reforms mentioned in this testimony. Second, we have formed a task force to review the entire conversion process and will work with the OTS on an approach for regulating the conversion process in the long term. While the task force has just begun its work, our testimony will outline our preliminary thinking on the issues, assuming that the mechanics can be satisfactorily worked out.

We acknowledge that many of these issues were considered by the Federal Home Loan Bank Board ("FHLBB") 20 years ago and that many of the following preliminary conclusions were ultimately rejected in the FHLBB's rulemaking process. However, we believe that the current process may need to be reformed and that these issues ought to be reexamined thoroughly under existing conditions in the industry.

1. The essence of the conversion process should be a distribution to depositors (and others, if deemed appropriate) of transferable stock purchase rights, accompanied by appropriate disclosure documents.

2. Depositors should have a vote on the transaction, even where State law does not require it. General proxies granted by depositors when they open accounts should not be valid. A "quorum" of 50 percent of eligible votes should be required. We are uncertain whether a simple majority, or a supermajority, should be required.

3. Depositors' eligibility for receipt of rights should be based on an existing relationship of some specific duration. This raises a host of issues that need further consideration. Some have suggested a record date of 6 to 12 months prior to announcement; however, eligibility issues require much additional study.

4. We are uncertain whether the distribution of rights should or should not reflect *amounts* on deposit—*e.g.*, one right per $100 on deposit up to a maximum of 10 rights per individual. Perhaps economic rights should mirror voting rights. This subject calls for further study.

5. The proxy statement and/or disclosure documents should probably include the opinion of an independent financial advisor regarding the fairness of the transaction to depositors from a financial point of view. Except in the case of a merger conversion, this will not be the same thing as an appraisal, and appraisals as such would not be required. The market will decide what the converting institution—and the rights—are worth. The purpose of requiring an independent advisor's opinion would be to avoid transactions which are so ill-conceived as to destroy value or make it difficult for depositors to realize that value. It should be clearly stated that this opinion does not address the question of whether the stock of the converting institution (or the acquiror in the case of merger conversions) is an appropriate investment for any particular depositor.

6. As indicated earlier, the ability of depositors (and other recipients) who do not wish to become stockholders to obtain fair value for their rights depends on the participation of underwriters and/or other dealers. We look forward to hearing from Wall Street and others about how the conversion process can be made fair and effective in this area.

7. The amount of capital to be raised in the conversion process should be appropriate to the institution's condition and reasonable business plan. Except in the case of a merger conversion, the converting institution should sell some new stock, however, and not just mail out stock certificates, as the public offering process is what gets investment bankers and investors to focus on the correct valuation of the company.

8. If tax law does not already make this clear, the distribution of rights should not be a taxable event, but the basis of the rights in the hands of initial recipients should be zero (and they should be capital assets). When depositors (and any other recipients) sell rights, or when they sell the underlying shares, Government will therefore obtain a portion of the economic value of the converting institution by taxing the gain on the sale.

9. With depositor approval, boards of converting institutions should be able to contribute some portion of the economic value of the institution, by contributing rights, to new or existing charitable trusts or organizations whose focus is the community the institution serves.

10. With depositor approval, it should be possible to contribute rights to a qualified Employee Stock Option Plan (ESOP).

11. In addition to meeting the test of no excessive compensation, any awards to officers and directors at the time of a conversion should be in the form of stock, not options, to avoid the conflict of interest of negotiating a transaction with the objective of giving the stock as high a value as possible, while having a personal interest in a low value. If a board wishes to institute a stock option plan, they can do so after conversion.

12. Merger conversions should, in essence, be exchanges of acquiror stock or cash for depositors' stock purchase rights. It should be feasible for potential acquirors to propose such transactions, subject to appropriate State and Federal laws. How this might work requires further study, however. We are uncomfortable with the idea of mutual institutions being forced to change their character, but are also uncomfortable with the notion that entrenched management could block a transaction that would deliver value to depositors and others and better protect one of the insurance funds from loss.

PROPOSED LEGISLATION

Mr. Chairman, you also asked for our comments on S. 1801, the "Mutual Depository Institution Protection Act of 1994," introduced by you and Senator D'Amato. In that regard I would make two comments. First, while we believe the FDIC has sufficient authority to curb abuses in the current process, we would need additional statutory authority if we proceed to reform the conversion process along the lines described above. We would strongly urge that our legislative mandate be general, and that the details be allowed to emerge from our rule-making process. Second, we believe that the FDIC and the OTS should each retain responsibility for supervising conversions of those institutions of which each is primary Federal regulator, but work together to assure comparable rules and procedures.

EMBARGOED
until Feb 25, 10 am

Testimony
of
Jonathan L. Fiechter, Acting Director
Office of Thrift Supervision

concerning

Mutual-to-Stock Conversions

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

February 25, 1994

Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington D.C. 20552
202•906•6288

INTRODUCTION

Good morning, Mr. Chairman and Members of the committee. Thank you for inviting me to provide the Office of Thrift Supervision's (OTS) views on regulating mutual-to-stock conversions and, specifically, on S. 1801, the Mutual Depository Institution Conversion Protection Act of 1994.

For the past 20 years—since the former Federal Home Loan Bank Board (FHLBB) implemented its mutual-to-stock conversion regulations in 1974—mutual-to-stock conversions have been a successful vehicle for bringing new capital into the thrift industry. Only a handful of mutual-to-stock conversions were conducted prior to 1974; however, since then, over 1,000 mutual savings associations have converted to the stock form of ownership, in the process raising approximately $16 billion in new capital. Almost 300 thrifts have converted in the last 4 years, raising nearly $5 billion in capital. During that same time, an additional 15 mutual institutions have formed mutual holding companies, raising $105 million.

As these numbers suggest, a principal benefit of an institution converting from the mutual to the stock form is raising capital, a result that can otherwise be difficult for mutuals to achieve. Mutual associations can increase their equity base only from retained earnings. This can be a lengthy process. Capital-deficient mutuals, in particular, have an incentive promptly to raise capital in order to achieve capital adequacy and thus avoid the wide range of regulatory and supervisory actions that regulators take against inadequately capitalized institutions. While a mutual may issue subordinated debt, the interest payment feature of the debt and the limitations on its use for meeting regulatory capital requirements may make it unattractive or inadequate to meet the institution's capital needs.

Often a mutual-to-stock conversion by a healthy institution results in a quick appreciation in the value of the stock. This makes the transaction attractive to the institution's insiders, *i.e.,* its officers and directors, because of the opportunity for those insiders to realize a profit—often a substantial profit—on the stock they purchase or are otherwise given in the form of management benefit plans in the conversion transaction. This aspect of the transaction has recently drawn a great deal of attention. It is, as I will shortly discuss, one of the focal points of OTS regulation. I believe it would be useful to begin, however, with an overview of the mechanics of a mutual-to-stock conversion.

OVERVIEW OF THE MUTUAL-TO-STOCK CONVERSION PROCESS

Types of Conversions

A mutual-to-stock conversion may be structured as a standard conversion or holding company conversion, a merger conversion, or a mutual holding company reorganization.

A standard conversion simply involves a mutual institution converting to stock form—the conversion stock offered for sale is the stock of the converted institution. A slight variant that is more common today involves a mutual institution converting to the stock form in connection with the formation of a holding company. In this type of transaction, called a holding company conversion, stock of the holding company is offered for sale and the converting institution becomes wholly owned by the holding company.

A second form of conversion is a merger conversion, involving the acquisition of the mutual institution by a stock institution. In this case the stock of the acquiring institution (or its holding company) is issued in the conversion, and the mutual thrift is merged into the acquiring institution.

Finally, a mutual institution may undertake a mutual holding company reorganization. This transaction is a structural hybrid of a standard and a holding company conversion. A mutual institution charters a subsidiary stock institution and transfers substantially all of its assets and liabilities to the stock subsidiary. The original mutual institution then becomes a mutual holding company by adopting a new mutual holding company charter. In effect, the mutual account holders of the thrift become the owners of the mutual holding company. This structure permits the resulting stock subsidiary to issue up to 49.9 percent of its stock to persons other than its mutual holding company parent. Generally, under OTS regulations, mutual holding company transactions are subject to the same requirements of the conversion regulations applicable to other types of conversions.

The Conversion Transaction

The decision to convert a mutual institution is typically initiated by the institution's board of directors. After a mutual's directors decide to convert, they adopt a plan of conversion and file a conversion application with the appropriate regulator and notify the mutual's account holders.

The conversion application filed with the regulator usually includes the plan of conversion, a copy of the proxy statement (and all proxy soliciting materials) to be sent to account holders seeking their approval of the conversion, and an offering circular registering the conversion stock. In addition, the institution is generally required to provide some form of valuation of the conversion stock.

If the conversion application receives regulatory approval, the plan of conversion is usually submitted to a vote at a special meeting of account holders. In most cases, a majority of the total outstanding votes of account holders is required to approve the plan of conversion. Account holders may vote in person or by proxy. In the event that account holders do not return the proxy materials, attend the special meeting, or otherwise revoke so-called "running" proxies—proxies executed by account holders at the time they opened an account—management may use the running proxies to vote for approval of the conversion. Federal law requires management to inform account holders of the intent to vote running proxies.

In the conversion process, priorities and incentives are typically established with respect to the purchase of conversion stock. Priority purchase rights may be extended to account holders, the mutual's officers and directors, employee stock benefit plans, such as employee stock ownership plans (ESOP's) and management recognition and retention plans (MRP's), and to members of the general public residing in the communities where the association has offices. Purchase priorities are established to permit individual members of one group to purchase up to a designated amount of stock before members of the group next in priority may make any purchases.

For example, account holders could be provided first priority to purchase the conversion stock through the receipt of nontransferable subscription rights. In the event of an over-subscription of conversion stock by account holders (if account holders offer to purchase more stock than the total conversion stock offered), shares would be allocated among the subscribers on a *pro rata* basis.

Under Federal law, upon consummation of a conversion, an institution is required to establish and maintain a "liquidation account"—equal to the mutual's retained earnings—for the benefit of existing account holders. This account is intended to recognize the intangible ownership interest of mutual account holders in the net worth of the mutual institution prior to conversion. Each mutual account holder has a sub-account in the liquidation account based on his or her *pro rata* portion of the institution's net worth prior to conversion, adjusted annually to reflect account withdrawals.

Although the average depositor does not open an account at a mutual institution in order to be able to purchase stock in the institution, such an account represents, along with all other accounts, a proportionate ownership interest in the going concern that is the mutual institution. Traditionally, most mutual account holders have executed running proxies, thereby choosing not to exercise the same degree of control over management of the mutual as shareholders do in a stock institution. Collectively, however, such account holders do own the assets that constitute the operating capital of the mutual—although they are not liable for the liabilities of the mutual. The liquidation account and conversion stock subscription rights and priorities established for mutual account holders under Federal law are intended to recognize the ownership interest of mutual account holders in the mutual.

A conversion does not affect the normal day-to-day operations of an institution. Account holders continue to hold accounts in the converted institution in the same amount and at the same rate of return and general terms. Borrowers' loans are also unaffected by the conversion. The amount, interest rate, maturity, security, and other conditions of outstanding loans are unaffected by the conversion.

History of the Federal Conversion Regulations

Prior to 1948, all savings associations operated as mutual associations. When Congress authorized savings associations to convert from the mutual to the stock form in 1948, concerns were immediately raised regarding conversions and the distribution of the net worth of the mutual institution among potential owners of the new stock. To the extent that holders of the new stock in converting institutions realized immediate gains on their investments, the result could be increased volatility in thrift deposits as would-be investor/depositors shifted funds among thrifts in search of soon-to-be converted institutions. In addition, the potential for large gains would place undue pressure on mutuals to convert, and would increase the potential for abuse by insiders seeking to reap a disproportionate share of any gains resulting from conversions. Because of these concerns, the FHLBB and Congress imposed various moratoria on conversions until 1974. As a result, between 1948 and 1974, only a small number of conversions were completed.

In an effort to address these concerns, the FHLBB proposed conversion regulations and held public hearings on them in 1973. At the same time, Congress also held hearings on the need for legislation in this area. Following the agency and Congressional hearings, the FHLBB revised its proposed conversion regulations in late 1973, and adopted them in 1974.

It was generally believed that the new regulations adequately addressed the problems arising from conversion "windfalls." As a result, Congress allowed its conversion moratorium to expire on June 30, 1974; these regulations continue in effect today.

KEY SAFEGUARDS CONTAINED IN OTS CONVERSION RULES

The conversion from a mutual form of ownership to stock ownership creates several concerns. In a mutual-to-stock conversion, the mutual's insiders are the parties who initiate and set the terms for the sale of the stock. But they are also potential purchasers of the stock. They, like any purchasers, are motivated to buy low in order to maximize the stock's value to them in the post-conversion market ("aftermarket") for the stock. The account holders who have an ownership interest in the mutual institution are also potential stock purchasers. As such, they too will benefit from the stock's appreciation in the aftermarket.

Thus, when a mutual institution converts to stock form, the transaction is one-sided. There are "typically motivated" buyers for the stock, but in a mutual conversion there are no "typically motivated" sellers, that is, sellers interested in achieving the highest possible price for the stock. The market thus does not exert discipline over the transaction—the usual tension between seller and buyer is lacking.

It is this absence of market discipline that is most troublesome and creates the potential for abuse. OTS regulation is designed to counteract this tendency by imposing limits or controls on insiders' activities in connection with mutual-to-stock conversions. The overarching control is that these conversion transactions cannot be consummated without OTS approval. To receive OTS approval, an institution must meet the following conditions:

- Specific subscription priorities are established for the purchase of conversion stock. First priority (after any tax-qualified ESOP purchases) goes to savings account holders with the institution at least 90 days prior to the date of adoption of the plan of conversion. The second priority goes to all other account holders. A third priority may be established for management and employee stock purchases. Finally, any stock not sold in the subscription offering must be sold to the public.
- Purchases by officers and directors in the aggregate are limited to between 25 percent and 35 percent of the total conversion stock offering, depending on the asset size of the converting institution. Moreover, no person, alone or acting in concert with others, may purchase more than 5 percent of the conversion stock—and the institution may set a lower purchase limitation. Finally, in no event may a converting institution loan funds to any person for the purpose of purchasing its conversion stock.
- In addition to the individual and aggregate management purchase limits, a converting institution may establish one or more tax-qualified ESOP's that may purchase, in the aggregate, up to 10 percent of the conversion stock on a first-priority basis. An institution may also establish non-tax-qualified plans, but these do not have any purchase priority, and stock allocable to management must be aggregated with other conversion stock for purposes of individual and aggregate management purchase limits.
- All management compensation plans are subject to review and approval by the OTS.
- The conversion stock must be sold at a price equal to the estimated *pro forma* market value of the converting institution's stock, based on an independent valuation, on or about the date of the conversion. The appraisal is reviewed by the OTS to ensure there is adequate data to support the estimated *pro forma* market value, for conformity with appraisal methodology and documentation standards, and to verify the appraiser's experience and independence.
- A majority of account holders must approve the conversion, and account holders must be furnished with a written proxy statement describing operation of, and their rights and role in, the conversion process. Proxy materials used to solicit votes must comply with the disclosure requirements of the Federal securities laws and specific thrift disclosure requirements established by the OTS, and must be reviewed and cleared by OTS staff prior to use. In addition, management may only use pre-existing "running" proxies to vote on the conversion if account holders do not vote their special conversion proxies.

- As with the proxy materials, the offering circular used to solicit account holders and others to purchase the conversion stock must comply with the Federal securities laws and specific OTS requirements, must contain audited financial statements, and must be approved prior to issuance.
- The conversion application must be accompanied by a business plan, subject to review and approval of the OTS, that describes the institution's intended use of the conversion proceeds.

The OTS conversion regulations, comprehensive in scope and governing all aspects of the conversion process, set forth specific and detailed standards that have been consistently imposed without exception as regulatory requirements in conversion transactions over the years. These key regulatory controls are consistent with our understanding of the purpose and objectives of Congressional intent in allowing the mutual-to-stock conversion moratorium to expire in 1974.

CONVERSION REGULATION ISSUES

The nature of mutual-to-stock conversions and the dynamics of the marketplace make it difficult to write regulations in this area. In administering the conversion program, the OTS has revised its conversion regulations several times since 1974 and remains open to suggestions for further improvements.

We continue to believe that minimum regulatory standards in the conversion area are desirable to curb the potential for abuse inherent in the skewed economic incentives in mutual-to-stock conversions. If such conversion standards are appropriate for OTS-supervised mutuals, they are presumably appropriate for other mutual institutions that convert.

OTS's rules govern only mutual-to-stock conversions of OTS-supervised thrifts. They do not apply to conversions undertaken by state savings banks. OTS supervises approximately 850 Federal- and State-chartered mutual savings associations. Given the popularity of mutual-to-stock conversions, many of these mutual institutions may choose to convert to stock form. If these institutions change to a State savings bank charter before they convert to a stock institution, they will be subject to State conversion rules.

Differences in State and Federal Conversion Standards

A number of States closely follow Federal conversion rules. Some, however, do not. Differences in those States that do not follow the Federal rules primarily involve:

- the rights and priorities of mutual account holders to purchase conversion stock;
- the amount of conversion stock that institution insiders may purchase;
- the amount of permissible stock incentives that may be given to management; and
- the valuation of the converting institution (and conversion stock) at the time of the conversion.

In several States, insider purchasers are not subordinated, and in certain instances are placed ahead of account holder subscriptions for the conversion stock. At least one State imposes no limit on the aggregate amount of insider purchases; and although there is a 10 percent limit imposed on ESOP purchases, there is no express limit on the combination of insider, ESOP and MRP purchases. Some States do not appear to have any regulatory standards governing management compensation arrangements in conversion transactions. Others have standards that authorize purchases far in excess of applicable Federal rules.

Under Federal rules, tax-qualified ESOP's are limited to 10 percent of conversion stock, MRP's are limited to 3 percent or 4 percent (depending on the thrift's capital position) of conversion stock, and combined ESOP and MRP purchases are limited to 10 percent to 12 percent of conversion stock (depending on capital). Aggregate insider purchases are given a lower priority than depositors and are restricted to no more than 25 percent to 35 percent of the conversion stock, depending on the institution's asset size. Thus, in no event could aggregate insider, ESOP and MRP purchases exceed 47 percent of the conversion stock. In the typical OTS-supervised conversion, management ends up with significantly less than 47 percent of the conversion stock.

The Federal purchase priority rules represent a balance that has been struck by the agency during the last 20 years of its conversion program. The priorities and purchase limits imposed on insiders reflect a weighing of the ownership interests of mutual account holders, the value that has been added to the mutual during its lifetime by management, and the interests of the community where the institution conducts its operations. Certainly the judgments that have been made by the agency on the relative weights and priorities to be ascribed to each of these interests in the conversion process is open to debate—and we welcome suggestions on how to improve this process.

Another difference in Federal and State conversion regulation is the method for pricing the conversion stock. Under Federal regulations, a converting institution must issue and sell its stock at a total price equal to the estimated pro forma market value, based on an independent valuation, of the stock in the converted thrift. Approved and standardized valuation procedures must be used to make this valuation determination, and the appraisal report must include a complete and detailed description of the appraisal methodology employed. The appraisal is reviewed by the OTS to assess the sufficiency of the data to support the appraisal methodology utilized to value the institution for purposes of stock sold.

Although most State laws require that conversion stock must be sold at the estimated *pro forma* market value of the stock in the converted institution, appraisal requirements vary from State to State. As a result, it appears that the manner in which State savings banks are valued at the time of their conversion is inconsistent.

Recently, questions have been raised about the effectiveness of any appraisal process in ensuring that conversion stock is priced at fair market value. Determining the market value of an institution is more of an art than a science. In our experience, the initial appraisal filed with the agency is frequently rejected as too conservative and estimate of the fair market value of the converting institution. OTS staff estimates that, in recent years, approximately three-fourths of all appraisals were initially rejected by the OTS as too low.

As noted earlier, a conversion lacks the traditional willing buyer/willing seller tension that generally produces a fair market sales price. Thus, the tendency on the part of appraisers is to be conservative so as to avoid harming the buyers, the party whose interests predominate in the conversion because they are the only recognizable party in the transaction. The seller, the institution itself, can only be heard through the voices of its management—who are usually buyers of the conversion stock, and who retain the appraiser to value the institution.

Due to the nature of these relationships, the role of the regulator in the appraisal process is to exert discipline on the appraiser to estimate more accurately the true value of the institution upon completion of the conversion.

Generally, a valuation range for the converting institution can be determined by looking at a number of factors, including book value, earnings capacity, financial condition and capitalization, asset size, profit history, competitive market conditions, current market price for other similarly situated institutions (including thrifts that recently converted), the size of the offering, economic conditions, and current market conditions.

Although some of these factors are easily determinable, others are not. Often, the result is that either too great or too little emphasis is placed on certain factors by an appraiser and the agency will disagree with the valuation. Ultimately, the agency must be satisfied that the valuation range for the conversion stock that is established by the appraiser is acceptable. If not, the conversion will not proceed.

Because of the nature of this process and the difficulty in accurately predicting how the aftermarket will respond to the new stock institution, it is impossible to determine with certainty the fair market value of a converting institution. In addition, many newly converted institutions, like other companies that go public, often experience a "bump" in the value of their shares during the first several weeks of trading. The recent experience of the OTS is that, as a result of current market conditions, the aggregate increase in the price of a stock during the several months after conversion is in the range of 15 percent to 30 percent. Sometimes this price bump holds after the initial trading flurry, and other times it does not.

Recent Trends in Charter Conversions to State Savings Banks

State-chartered savings banks traditionally were BIF-insured institutions, located primarily in New England States. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), however, provided the authority for a savings association to become a State savings bank and avoid OTS jurisdiction; these changes in charters have been informally referred to as "Sasser" transactions. As a result of this FIRREA authorization, a number of states outside New England have sought to entice savings associations to shift to State savings bank charters.

Increasingly, mutual institutions that are choosing to convert to stock form find it advantageous to do so under State rules. Because Federal supervision of institutions that change to State savings bank charters shifts to the Federal Deposit Insurance Corporation (FDIC), OTS does not have comprehensive information on subsequent conversions by these institutions that have left our jurisdiction. We have observed, however, that over the past several years, the number of OTS-supervised mutual institutions that have changed to State savings bank charters has increased dramatically. For example, 51 North Carolina mutual institutions recently removed themselves from OTS jurisdiction in favor of North Carolina's State savings bank

charter. Of these, nearly half subsequently undertook a conversion—8 converted to stock institutions and an additional 16 were acquired by another institution in merger conversions. During the same time, only 2 North Carolina mutuals supervised by the OTS undertook similar conversions. Similar patterns exist in Pennsylvania, Wisconsin, and New Jersey.

Of course, differences in Federal and State conversion standards are not the only incentives for OTS-supervised thrifts to change charters. Institutions changing charters can shift supervisory expenses. For instance, OTS-supervised thrifts, whether Federal- or State-chartered, pay for their examinations through explicit fees. By contrast, the FDIC's expenses of examining State savings banks are borne by the deposit insurance fund and thus by all insured institutions that are members of the fund. OTS-supervised thrifts are required to hold stock in the FHLBank System and thus, indirectly, must contribute to the Resolution Funding Corporation and affordable housing obligations of the FHLBank System. Thrifts that change to State savings banks, by contrast, may redeem their FHLBank stock and avoid such obligations.

Merger Conversions

Of the recent spate of mutual institution conversions, the transactions that have drawn the most attention are merger conversions. The structure of these transactions raises unique issues not involved in other types of conversions. These include the adequacy of the consideration paid by an acquiror; whether a "control" premium should be incorporated into the valuation of the mutual institution; the treatment of the mutual account holders in connection with the distribution of conversion stock; whether mutual account holders should be able to purchase the conversion stock at a discount and the amount of such discount; and the appropriateness of management compensation arrangements and stock incentive packages offered by an acquiror to coax the mutual's management into the merger conversion.

As a result of the controversy surrounding merger conversions, the OTS recently imposed a moratorium on healthy thrifts entering into these transactions. The moratorium is intended to provide the agency staff with the opportunity to review the merits of merger conversions including whether additional safeguards are necessary to protect the mutual target's account holders, whether limits on management compensation and stock arrangements are needed, and the nature and amount of any such limits.

The moratorium would not block the acquisition of an undercapitalized thrift by a healthy institution. In addition, the moratorium is not intended to interfere with bank acquisitions of stock thrifts.

S. 1801, The Mutual Depository Institution Conversion Protection Act of 1994

With respect to the OTS's views on S. 1801, we support the application of consistent standards on Federal and State mutual-to-stock conversions. We defer to the FDIC to answer the question of whether legislation is needed to ensure the application of consistent standards to Federal and State conversions. The FDIC recently issued for public comment a proposed policy statement on conversions of State-chartered savings banks. In addition, on February 9, 1994, the FDIC adopted an interim final rule requiring FDIC review of all State savings bank conversions during the pendency of the policy statement.

The FDIC policy statement solicits comment on the need for the FDIC to regulate State savings bank conversions, the agency's jurisdiction over such transactions, and the need for protections to ensure correct pricing of conversion stock, equitable apportioning of stock subscription rights (including avoiding excessive "windfall" gains to insiders), and adequate disclosure in conversion offering materials.

Conclusion

Mutual-to-stock conversions provide an opportunity for an institution to raise capital. Mutual-to-stock conversions may also tempt an institution's insiders to engage in transactions that transfer an inappropriate amount of the institution's value to the institution's insiders.

The OTS mutual-to-stock conversion regulations reflect standards and safeguards developed over the years to counteract the lack of market discipline in the process and to respond to the potential for abuses in thrift conversions. Some States do not provide depositors with the same level of safeguards.

We believe there is no compelling reason to permit what amounts to "regulatory arbitrage" that may disadvantage depositors or their local communities. To the extent that there have been abuses in the conversion process, consistent standards should be applied to correct those abuses. The issue is not OTS rules versus State

rules but identifying what abuses, if any, exist and applying uniform rules even if that means changing OTS rules.

PREPARED STATEMENT OF DERRICK D. CEPHAS

SUPERINTENDENT OF BANKS, NEW YORK STATE

Good morning Mr. Chairman and Members of the committee. My name is Derrick Cephas and I am the Superintendent of Banks of the State of New York. I appreciate the opportunity to appear before the committee today to present the views of the New York State Banking Department.

The issue of conversion of savings institutions from mutual-to-stock form ownership has commanded the attention of the banking industry for several months now. We in New York have had occasion to review this issue in some depth recently and, in that connection, I would like to include in the record of this hearing a copy of a policy statement which my office issued yesterday. Finally, before I turn to the substance of my remarks today, I would also like to respectfully ask for the committee's understanding of my desire to limit my remarks today to stock conversions in general and not to comment on any particular institution or any particular transaction.

Chairman Riegle's letter confirming my participation set forth several questions which the committee sought to have addressed. I will address them individually:

I. WHO OWNS A MUTUAL INSTITUTION?

Under New York law, no one "owns" a mutual institution. That is clearly the answer under New York law and, as far as I am aware, it is also the law in every other jurisdiction in the United States. A New York court, as recently as January, 1994, affirmed this conclusion. Neither the depositors, nor the management and trustees nor the community "owns" a mutual institution. Because of this unique status, the responsibility, I believe, falls to the bank regulators to protect the public interest in the conversion process.

II. WHAT PARTIES, IF ANY, SHOULD RECEIVE PRIORITY RIGHTS IN A CONVERSION?

I assume that the term "priority rights" refers to rights to subscribe for the stock to be issued in a conversion. Under New York law, in a public offering of stock in connection with a conversion, all persons or entities who were depositors of a mutual institution as of a fixed record date receive a priority to subscribe for shares of the stock to be issued in the conversion, subject to proration in the event of an over-subscription. In addition, these same depositors are vested with the authority to approve or disapprove of the conversion by voting for or against it at a special meeting of depositors called for that purpose. Under the circumstances, this process has worked rather well in New York.

There are, however, two instances under New York law in which depositors do not receive a priority in the purchase of stock. Both of these instances involve transactions in which the board of trustees of the converting institution has decided to enter into a sale of control conversion pursuant to which ownership or control of the converting institution is acquired by one or more persons. If the proposed conversion involves an institution in a weakened financial position (under 3 percent net worth), the converting institution is allowed to convert without providing depositors with a right to purchase the stock. If the converting institution has net worth of 3 percent or more, although depositors have no right to purchase stock in the conversion, the converting institution must allow competing offerors to present bids to depositors for the converting institution on an equal basis. In sum, New York law provides for: (i) depositor priority in the purchase of stock in all public offerings; (ii) depositor vote to approve or disapprove of conversions in all cases (except in failing bank situations); (iii) uncontested sales of control only in the context of undercapitalized institutions; and (iv) contested sales of control in other contexts in which depositors approve the transaction.

In most cases, depositors should clearly receive priority rights to purchase stock. In an effort to facilitate the conversion of financially weak institutions and to add greater flexibility to the conversion process, we have deviated from this standard in the "sale of control" examples outlined above.

III. TO WHAT EXTENT SHOULD MANAGEMENT AND INSIDERS BE ALLOWED TO PARTICIPATE IN A CONVERSION? SHOULD THEY RECEIVE A PREFERENCE OVER DEPOSITORS?

By "participate," I assume that the question refers to the ability to purchase stock in the conversion. As I stated earlier, depositors in New York usually receive a pri-

ority to purchase stock in a conversion. To the extent that "management and insiders" are also depositors, they are entitled to purchase stock on the same basis as all other depositors. We believe this to be an equitable policy.

Although it has never in fact occurred, it is possible under New York law for "management and insiders" to "receive preference over depositors" in a sale of control conversion by purchasing stock in the converting institution without offering subscription rights to depositors. This transaction, however, could not be consummated without the prior approval of the depositors of the converting institution.

With respect to compensation payable to management and insiders as part of the conversion, the Banking Department has already proposed regulations that would require the compensation arrangements of management and the trustees to be reviewed for fairness to the converting institution and its depositors. This requirement is particularly important in view of the fact that in the typical conversion there are no disinterested directors to review such compensation plans. While management and the trustees should be permitted to receive fair and reasonable compensation, including incentive compensation, for their contributions to the institution, the wholesale transfer of material amounts of the net worth of converting institutions to management and trustees should not be allowed.

IV. How effective is the current appraisal process in ensuring that the stock is priced at fair market value?

This is a rather complex question and one that is under the active review of the Banking Department. We believe that the appraisal process warrants significantly closer scrutiny and we hope to be able to work with the Federal regulators in reviewing the appraisal guidelines currently in use. New York State requires appraisals to be completed pursuant to the OTS Appraisal Guidelines since we have not issued our own procedures in this area. Pending a review of the existing guidelines, we are considering supplementing the existing OTS Appraisal Guidelines for use in New York by: (i) defining "*pro forma* market value" as the estimated market value of the converting institution immediately after the consummation of the planned conversion, after giving effect to the receipt of the new proceeds and to a reasonable "new issue discount"; (ii) prohibiting the appraiser from employing an assumed rate of return on the conversion proceeds if the appraiser knows or should know that the converting institution will use the proceeds in a manner that will produce a rate of return in excess of the assumed rate; and (iii) prohibiting the appraiser from basing the appraisal in whole or in part upon information received from the converting institution which the appraiser believes or has reason to believe, after inquiry and the exercise of its professional judgment, is inaccurate, incomplete, or unreasonable.

V. Do sufficient safeguards exist to ensure that the conversion proceeds are utilized productively?

We believe that regulatory procedures in this area may well need enhancement. In that connection, we have proposed in our policy statement of February 24, 1994 that the board of trustees of converting institutions adopt a business plan prior to or contemporaneous with adopting a plan of conversion, which business plan would be filed with the Banking Department and would set forth, at a minimum: (i) the institution's reasons for converting; (ii) its planned use of the conversion proceeds; (iii) its plans with respect to the payment of dividends and the repurchase of stock to be issued in the conversion; and (iv) the anticipated effect of the conversion on the institution's traditional lines of business and its ability to serve its customers after the conversion. Generic business plans which rely upon extensive use of "boiler plate" language will not be deemed to fulfill this requirement.

VI. What issues are raised in merger conversions, and how should such proposals be evaluated?

Merger conversions raise a number of concerns, most of which have already been identified by the committee in the questions discussed earlier in my testimony. In general, merger conversions raise issues relating to fairness to depositors and preferences and financial benefits received by management and the trustees. However, the fact that depositors of the converting institution are allowed to subscribe for stock of the acquiring institution rather than of the converting institution is the principal issue raised by a merger conversion which is not present in a so-called "stand alone" conversion in which the converting institution issues its stock to the public. If the stock of the converting institution is priced at a "bargain" price as some have argued (which, of course, raises other issues), then the depositors who might have purchased stock in the conversion are deprived of the benefit of that bargain since in a merger conversion they are offered the opportunity to purchase the stock of the acquiring entity only. The other issue often raised in the merger conversion context involves the fact that the acquiring bank in effect is able to "pur-

chase" the converting institution at no real cost. Many have complained about this aspect of merger conversions. However, prior depositor approval would be required, even in the context of a merger conversion.

* * *

As to our evaluation of S. 1801 and our assessment of the effectiveness of current law in ensuring a fair and equitable conversion process, let me first make a few general observations. Conversions raise a number of enormously complicated policy issues. As regulators, we are faced with large financial institutions with large capital bases which are owned by no one. Many constituencies lay claim to owning or having an interest in the net worth of mutuals, but the fact is that none of those claims have any basis in law. Converting from mutual-to-stock form is a legitimate business objective and has over the years allowed the thrift industry to raise billions of dollars of additional capital. I believe that we all should be supportive of that objective.

The narrow question then arises as to how best to regulate a thrift institution *in its transition* as it changes from mutual-to-stock form. As we have outlined in our policy statement attached to this testimony, there are a number of policy recommendations which we are considering. The rules and regulations applicable to conversions are and should be evolutionary in nature. As markets change and as corporate practices and other circumstances change, the regulatory system should respond to the changing circumstances. That is what we have attempted to do in New York at the regulatory level—to revise our conversion regulations in view of present day business practices and market realities.

As to this committee's proposal to enact S. 1801, first let me say that as a bank regulator, especially a State bank regulator, we as an institution would always prefer to be given the opportunity to resolve issues at the regulatory level and at the State level. I realize that this committee and this body, for which I have enormous respect, have different institutional imperatives than the New York State Banking Department, and that our preferences may not be consistent with your governmental responsibilities.

Having said that, let me also say that I understand and appreciate the concerns which the committee is attempting to address with S. 1801. The issues which the committee has focussed on certainly need to be addressed and the committee has rightfully, I believe, brought public attention to these important matters.

If the committee and the full Senate proceed to enact S. 1801, I would like to respectfully make two observations:

1. I believe that significant flexibility should be maintained at the regulatory level. There are many judgments to be made in the conversion process and, while the Senate certainly has the expertise to make such judgments, the regulatory apparatus is less cumbersome and is able to respond more quickly than legislative bodies in this regard.

2. As to the proposed Treasury Department study, I would respectfully suggest that the committee consider shortening the time period called for in the study from 1 year to 6 months. There is currently a cloud of uncertainty hanging over the entire field of conversions, which should be removed as soon as practicable. While the subject matter of the Treasury study is important, it is also important that the study be completed on an expedited basis so that those banks which determine to convert can continue to do so with the minimum of regulatory uncertainty. The public market for converting thrifts has been exceedingly hospitable in recent times, but no one knows how long it will remain so. Care should be taken not to impede the conversion process more than necessary to address legitimate supervisory and regulatory concerns.

I appreciate the opportunity to appear before the committee today and I hope that my comments have been useful to the committee in its deliberations. Thank you very much.

ADDITIONAL STATEMENT OF DERRICK D. CEPHAS

SUPERINTENDENT OF BANKS, STATE OF NEW YORK

TO THE CHIEF EXECUTIVE OFFICER OF THE INSTITUTION ADDRESSED:

The thrift industry in New York has made and continues to make significant contributions to the State's economic well being. Thrift institutions are among the banking industry's leaders in local community lending and the offering of other

basic banking services. Home mortgages, low-cost checking accounts and small business loans are the staple of the great majority of New York thrift institutions. The management, trustees, and directors of most of these institutions have been particularly civic-minded, serving their communities in numerous capacities beyond the brick and mortar confines of their particular institutions. Today, we have 66 State chartered savings banks and savings and loan associations in New York, 19 of which are organized in stock form and 47 of which are organized as mutuals. We believe that these institutions—whether organized in mutual or stock form—will continue to serve the public as they have in the past.

Recently, there has been significant public attention focussed on the conversion of mutual thrift institutions to stock form. These conversions raise a number of very difficult legal and public policy issues. Since early November of 1993, the Banking Department has had occasion to review in detail the statutes, regulations, and policies applicable to the conversion of thrift institutions from mutual-to-stock form under New York law. As a result of the conversion of several highly capitalized thrift institutions, the inclusion of lucrative compensation packages in several recent plans of conversion and the many issues raised in connection with the conversion of The Green Point Savings Bank, we find ourselves at a critical juncture in the evolution of mutual-to-stock conversions in New York.[1]

In addressing the issues set forth in this letter, we are guided by our interest in creating a regulatory structure that remains hospitable to conversions. We do not believe that any legitimate public policy interest would be served if our policies and procedures discouraged or inhibited conversions. It is important that conversions to stock form remain available and viable as an avenue for bringing new capital into the thrift industry. Mutual thrifts desiring to convert should be able to do so under a set of rules which balances in a fair and equitable manner the various competing interests present in the conversion context. We also firmly believe that those thrift institutions which desire to remain in mutual form should be allowed to do so.

Except in the case of a supervisory conversion, the decision whether or not to convert rests solely with the trustees of a mutual institution. Similarly, the trustees are also empowered to decide the manner in which a thrift will convert. Thus far, it has been in the second instance—the manner of conversion—that additional regulatory guidance and oversight appears to be needed. We believe that an attempt should be made to devise new regulations which more effectively protect the interests of the institutions, their depositors and the banking system in the conversion process.

BACKGROUND

On November 1, 1993, we issued a legal opinion (the "November 1 Letter") which, among other things, permitted the trustees of a converting thrift institution to, under certain circumstances, adopt a plan of conversion which contains a provision allowing for a payment of cash or other consideration to be paid to the depositors of the converting institution.[2]

On November 9, 1993, we issued a second letter (the "November 9 Letter") in an effort to clarify any ambiguity which might have arisen as a result of the issuance of the November 1 Letter. The November 9 Letter made it clear that a payment of cash or other consideration was permissible under New York law only under the specific circumstances set forth above in footnote 2 and that such payment could be offered, directly or indirectly, to the depositors of a converting thrift institution only by the trustees thereof as part of a plan of conversion duly adopted by such trustees.

On November 18, 1993, the Banking Department issued a statement (the "Interpretive Statement") in an effort to clarify, on an interim basis, the policies and procedures applicable under New York law to (i) unsolicited offers to acquire mutual thrift institutions and (ii) proxy solicitations for depositor votes conducted in connection with mutual-to-stock conversions. The Interpretive Statement was followed on December 2, 1993 by several proposed amendments (the "December 2 Proposal") to

[1] We emphasize that the result reached by the Banking Department in The Green Point Savings Bank conversion is not to be viewed as a "model" for all future conversions in New York. The conversion of Green Point raised particularly difficult issues and the Order issued by the Department in that case was designed to address the specific facts and circumstances of that case only.

[2] The November 1 Letter permitted the trustees of a converting mutual thrift institution to include in their plan of conversion a payment of cash or other consideration, provided that such payment (i) was made in furtherance of a legitimate business objective of the converting institution, (ii) was not made primarily as an inducement to secure depositor votes in the conversion and (iii) did not raise any other safety and soundness concerns. The Department is reviewing the November 1 Letter in an effort to determine the advisability of continuing to permit special interest payments under New York law.

Part 86 of the General Regulations of the Banking Board (the "Banking Board"), which sets forth the applicable rules and procedures governing mutual-to-stock conversions in New York (the "Conversion Regulations").[3]

Among other things, the December 2 Proposal required an independent review by experts of (i) the reasonableness of the compensation payable to management and trustees in connection with a conversion as compared to the compensation received by management and directors of similar publicly traded banking institutions and (ii) the accuracy and adequacy of the appraisal of the "pro forma market value" of the institution and the fairness from a financial point of view of the consideration to be received by the institution in the conversion. Such proposal was issued for public comment and has not yet been adopted.

Prior to 1984, there was no authority under New York law for a mutual thrift institution to convert to stock form. In January of 1984, the New York State legislature amended the New York Banking Law (the "Banking Law") by enacting Chapter 1 of the Laws of 1984 (the "Authorizing Statute") to allow New York State chartered mutual thrift institutions to convert to stock form. Soon thereafter, the Banking Board promulgated the Conversion Regulations. The first conversion was consummated under New York law in August of 1984. Since then, 29 other mutual thrift institutions have converted to stock form in New York pursuant to the Conversion Regulations.

There has been significant change in the marketplace and in the financial condition of mutual thrifts since 1984 when the Authorizing Statute was enacted and the Conversion Regulations were promulgated. Prior to 1987, many converting thrift institutions were undercapitalized and a conversion to stock form provided the principal means by which thrifts could gain access to the public markets and enhance their capital positions. Undercapitalized or minimally capitalized thrifts, by offering stock subscriptions to their depositors, their communities and to the public, could achieve capital compliance as a result of the conversion. Indeed, in many cases the primary purpose of the conversion was to bring the converting institution into compliance with applicable capital requirements.

Today, the scenario is sometimes quite different. Mutual thrift institutions with capital far in excess of regulatory requirements often convert to stock form. Conversions have been structured which contain terms providing management and trustees with significant personal financial benefits. Institutions have sometimes converted on the basis of appraisals which may not have reflected the "full value"[4] of the converting institution. Some institutions, soon after conversion, repurchase material amounts of their newly issued stock. Commentators have criticized these types of conversions, often arguing that a primary purpose served by such conversions has been to distribute a significant portion of the institution's net worth to insiders and to provide a highly promising investment opportunity for the persons who purchase the stock in the conversion.[5]

Issues To Be Considered

There are several serious and novel policy issues to be addressed. There is first the question—almost Delphic in its complexity—as to who actually owns a mutual institution. In the context of today, this question is not merely an academic conundrum, given the significant net worth of many institutions. As appealing as it might be to conclude that depositors own mutual thrifts, that answer is simply at odds with the law. Although it may well be that depositors have a greater "moral" claim to ownership than any other constituency, the plain fact is that depositors do not "own" mutual thrift institutions as the term "ownership" is understood under New York law.[6] It is equally clear under the law that the managers of these institutions—namely, the officers and the trustees—also do not own them. These mutual institutions are legally owned by no one, but we believe that the public has a clear interest in them. Because of this unique status, the responsibility falls to us—bank regulators—to protect the public interest in the conversion process.

---

[3] 3 NYCRR Part 86.

[4] See "Guidelines for Appraisal Reports for the Valuation of Savings and Loan Associations and Savings Banks Converting from Mutual to Stock Form of Organization," published by the Federal Home Loan Bank Board, October 1983 (the "OTS Appraisal Guidelines").

[5] The purchasers of stock in conversions have tended to be only those depositors of the bank who possess the financial expertise necessary to allow them to fully appreciate the desirability of the investment. A very small percentage of depositors purchase stock in conversions; the vast majority do not.

[6] (See *In re East New York Savings Bank Depositors Litig.*, 547 N.Y. 2d 497,500 (Sup. Ct. N.Y. Co. 1989); and *Schembri v. Derrick D. Cephas, Superintendent of Banks of the State of New York*, Index No. 100495/94 (N.Y. Sup. Ct., January 25, 1994)).

There is the further question of the appropriate role of incumbent management and trustees in the conversion process. What are their fiduciary duties, and to whom are such duties owed? A trusteeship is not a mere honorary position. The trustees are fiduciaries and are charged with the duty to manage their institutions in accordance with applicable standards of care. As the title implies, a trustee occupies a position of trust in relation to the institution which he or she serves. The position carries with it a duty to the institution, its depositors and the community served by the institution. This duty has two clear components: first, the trustee must serve the institution with adequate diligence and care and; second, the trustee may not elevate his or her personal interests above those of the institution.

In view of these general pronouncements, consideration must be given to identifying with greater specificity the duties of trustees in the context of a conversion. One of the most important decisions to be made by a trustee of a mutual savings institution is the decision to either remain mutual or convert to stock form. That decision must be an informed one and must not be tainted by undue self-interest. Whether deciding to remain mutual or convert to stock form, trustees must put the interests of the institution, its depositors and the community above their own.

In that regard, the Banking Department is considering requiring the trustees of a converting thrift institution to adopt a business plan prior to or contemporaneous with adopting a plan of conversion, which business plan would be filed with the Banking Department and would set forth, at a minimum, (i) the institution's reasons for converting, (ii) its planned use of the conversion proceeds, (iii) its plans with respect to the payment of dividends and the repurchase of stock to be issued in the conversion and (iv) the anticipated effect of the conversion on the institution's traditional lines of business and its ability to serve its customers after the conversion. This requirement will serve to end the practice employed in the past by some converting institutions of converting pursuant to pre-packaged "conversion kits," under which all of the material terms of the conversion are established by the converting institution's advisers and not by the institution's board of trustees.

The Banking Department has, as part of the December 2 Proposal, already proposed regulations that would require the compensation arrangements of management and the trustees to be reviewed for fairness to the converting institution and its depositors. This requirement is particularly important in view of the fact that in the typical conversion there are no disinterested directors to review such compensation plans. While management and the trustees should be permitted to receive fair and reasonable compensation, including incentive compensation, for their contributions to the institution, the wholesale transfer of material amounts of the net worth of converting institutions to management and trustees should not be allowed.

The Banking Department is also considering revising the guidelines pursuant to which the appraisals of the "pro forma market value" of converting institutions are conducted. Some have argued that certain of the recent appraisals of converting thrifts have significantly underpriced the stock of such institutions, thereby depriving such institutions of the "full value" of the stock sold in the marketplace. There is evidence which appears to support this contention. The Department hopes to work closely with the Federal regulators to review existing appraisal procedures to determine what revisions, if any, are necessary and appropriate. In the meantime, we will consider supplementing the OTS Appraisal Guidelines for use in New York by (i) defining "*pro forma* market value" as the estimated market value of the converting institution immediately after the consummation of the planned conversion, after giving effect to the receipt of the new proceeds and to a reasonable "new issue discount," (ii) prohibiting the appraiser from employing an assumed rate of return on the conversion proceeds if the appraiser knows or should know, after inquiry, that the converting institution will use the proceeds in a manner that will produce a rate of return in excess of the assumed rate and (iii) prohibiting the appraiser from basing the appraisal in whole or in part upon information received from the converting institution which the appraiser believes or has reason to believe, after inquiry and the exercise of its professional judgment, is inaccurate, incomplete, or unreasonable.

An effort should also be directed toward re-examining the disclosures made in both the proxy materials and the offering materials with a view toward providing depositors with expanded disclosure of relevant information relating to the proposed conversion. For example, the information resulting from the development of the business plan referred to on page 8 above should be disclosed in both the proxy statement and the offering circular. Indeed, the depositors who elect not to purchase stock in the conversion should be entitled to receive significantly enhanced disclosures since, in many, jurisdictions, it is their vote which approves or disapproves of the conversion in the first instance.

In addition, it may well be that the proxy solicitation process requires substantially increased regulatory oversight. To the extent practicable, the proxy solicitation process should more closely follow the rules and procedures established by the Securities and Exchange Commission. Regulatory oversight should extend to telephone solicitations and solicitations conducted at bank premises as well as to the customary printed materials which are mailed to depositors. Voting procedures adopted by converting institutions which could have the effect of coercing depositors to cast their votes by proxy well before the date of the special meeting and well before such depositors might have had the opportunity to fully consider the conversion should be prohibited.

SPECIFIC RECOMMENDATIONS

In view of the discussion set forth above, we are considering proposing for public comment in the near future a comprehensive revision of the Conversion Regulations which would contain, among others, the following provisions:

1. A mutual institution whose board of trustees decides, in good faith and consistent with its fiduciary duties, to remain in mutual form may do so, free of implicit or explicit coercion from the regulatory system or the marketplace.

2. The board of trustees of a converting institution which decides to effect a Type A Conversion (as defined in Exhibit A), in good faith and consistent with its fiduciary duties, shall be allowed to do so under New York law free of implicit or explicit coercion or interference from the marketplace.

3. The board of trustees of a converting institution which decides to effect a Type B Conversion (as defined in Exhibit A) shall be required to present acquisition offers (or offers proposing other types of conversion transactions) received from other persons or entities to the depositors of such institution for a vote.

4. The board of trustees of a converting institution shall be required to certify in form and substance satisfactory to the Banking Department that it has reviewed and considered the appraisal of the *pro forma* market value of such institution performed in connection with the conversion (including the assumptions used therein) and has accepted and adopted its conclusions.

5. All proxy cards executed and voted by depositors in connection with a conversion shall be received, held and counted by a tabulator independent of the converting institution. All such cards shall be mailed or delivered directly to the independent tabulator and shall not be handled by the converting institution. Proxy cards executed on the premises of, or delivered to, the converting institution by depositors shall be placed by such depositors in a secure receptacle which shall be delivered intact to the independent tabulator without having been opened on the premises of the converting institution.

6. In a Type A Conversion, only depositors of the converting institution will be permitted to solicit proxies in opposition to the plan of conversion proposed by the trustees of the converting institution and no interested party (as defined in the Conversion Regulations) will be permitted to finance any such proxy solicitation conducted by any such depositor.

7. In a Type B Conversion, interested parties (as defined in the Conversion Regulations) as well as depositors will be permitted to solicit proxies in opposition to the plan of conversion proposed by the trustees of the converting institution, as contemplated by Section 86.6(b) of the Conversion Regulations. Interested parties will also be permitted to engage in other activities relating to the proposed conversion in furtherance of its interests.

8. The guidelines for conducting appraisals of converting institutions will provide the appraisers with more direction in the completion of appraisals than is currently provided. Pending the completion of our review of the appraisal process and consistent with any measures adopted by the Federal regulators, we will consider supplementing the OTS Appraisal Guidelines for use in New York in the manner set forth on page 10 hereof.

9. The trustees of a converting thrift institution will be required to adopt a business plan prior to or contemporaneous with adopting a plan of conversion as described on page 8 hereof. Generic business plans which rely upon extensive use of "boiler plate" language will not be accepted by the Banking Department.

By proposing two types of conversions—Type A Conversions and Type B Conversions—the Banking Department has attempted to distinguish between public offerings of stock by converting institutions pursuant to which no person or persons will own or control such institutions after the conversion from those transactions which provide for an acquisition of control of the converting institution. In the former case, such conversions will not be made subject to competing offers or any other type of coercion or interference in the marketplace. In the latter case, mutual institutions which determine to convert pursuant to a plan of conversion which transfers control

to an acquiror (which shall include all merger conversions and any other conversion which transfers (directly or indirectly) more than 9.9 percent of the voting stock to any person or entity (including management and the trustees) shall be required to present to the depositors for a vote all other proposals to acquire control of such converting institution or to otherwise convert such institution to stock form.

The other specific recommendations are intended to bring a greater degree of fairness and reasonableness to the conversion process. There may be other issues of equal or greater importance which should be addressed. We would greatly appreciate receiving written comments on the proposals set forth in this letter and on any other relevant issues which we may not have raised or adequately addressed herein. Please address your comments to Peter Philbin, Deputy Superintendent of Banks—Thrifts Division, 2 Rector Street, New York, NY 10006. It would be helpful if we could receive your comments on or before April 15, 1994.

EXHIBIT A

PART I.

A Type A Conversion shall be defined as a conversion adopted by the trustees of a converting institution which satisfies all of the following requirements:

1. The trustees and management of the converting institution shall not own or control or have the right to own or control, directly or indirectly, more than 9.9 percent of the stock issued pursuant to the conversion as of the consummation of the conversion, and neither management nor the trustees has any reason to believe that such persons will, in the aggregate, acquire more than 9.9 percent of such stock prior to the first anniversary of the effective date of the conversion; and

2. The converting institution does not establish in connection with the conversion any benefit plans which include any stock grants to the trustees or executive officers and commits not to establish any such plans prior to the first anniversary of the effective date of the conversion; and

3. The converting institution does not establish in connection with the conversion any stock option plans which provides either (i) for the exercise of any options granted thereunder prior to the first anniversary of the effective date of the conversion or (ii) for the grant of any such options at an exercise price which is established with reference to the market price of the stock issued in the conversion on any date prior to 60 days after the effective date of the conversion; and

4. The converting institution commits that it will not directly or indirectly repurchase any of its outstanding common stock prior to the first anniversary of the effective date of the conversion; and

5. Immediately after the completion of the conversion, no person or persons acting in concert (including management and trustees of the institution) will own or control, or have the right to own or control, directly or indirectly, more than 9.9 percent of the outstanding stock of the converting institution.

PART II.

A Type B Conversion shall be defined as any conversion, including a merger conversion, which is not a Type A Conversion. A Type B Conversion shall be deemed to be a sale of control conversion as contemplated by Section 86.6 of the Conversion Regulations. The compensation provided for in a Type B Conversion shall not exceed the compensation which would be permissible in a Type A Conversion.

PREPARED TESTIMONY WILLIAM J. DRUMM

SUPERINTENDENT, DIVISION OF SAVINGS & LOAN ASSOCIATIONS/
DIVISION OF SAVINGS BANKS, STATE OF OHIO AND
CHAIRMAN-ELECT OF THE AMERICAN COUNCIL OF STATE SAVINGS SUPERVISORS

Mr. Chairman and Members of the Committee:

My name is William J. Drumm. I am the Superintendent for both Savings & Loan Associations and Savings Banks for the State of Ohio and Chairman-Elect of the American Council of State Savings Supervisors. Thank you for the opportunity to testify before you today.

BACKGROUND INFORMATION

Ohio's thrift industry has traditionally been a strong competitive force within our State and is so regarded within the Nation.

As Superintendent, I am the primary regulator for both State-chartered savings and loan associations and savings banks in Ohio. As of February 1, 1994, there were 85 State-chartered savings and loans, and 20 State-chartered savings banks in Ohio. The combined assets of these institutions approximates $14.5 billion. I am pleased to report that our institutions are basically in good financial condition, and that, out of 105 institutions, only seven institutions are rated 3 or below on either the MACRO or CAMEL rating system.

In 1991, the savings bank charter, as defined in Chapter 1161 of the Ohio Revised Code, was created in Ohio. The savings bank charter provides a new option for existing thrifts and commercial banks in Ohio, as well as for de novo charters. To date, 20 savings and loan associations, both State and federally chartered, have converted to State-chartered savings banks. At the present time, an application for a de novo savings bank charter is pending as are three additional charter conversions. Furthermore, of the 20 savings banks, 10 are stock companies and 10 are mutual companies.

Increasing Capital Requirements and the Savings Bank Charter

The recent trend in converting savings and loan associations to savings banks was inevitable. Continuing changes in Federal laws and regulations have mandated that overall capital levels in thrift companies be increased. In order to meet this mandate, management of these associations is required to look for ways to control expenses, increase income, and thus increase capital.

Mutual companies are automatically placed at a disadvantage. There is no mechanism whereby capital markets can be accessed by mutual companies to bolster their capital position. Their only source of additional capital is through cost control and increased earnings. Most often management has to shrink the assets of the company, thus decreasing funds available for customer borrowing and enhancing the perceived credit crunch.

The best option available to mutual companies is conversion to a stock company. This provides the vehicle to access capital markets to increase capital as necessary. These conversions provide flexibility in meeting the capital needs of a company based upon both the actual performance of the company and changing regulatory capital requirements.

Unfortunately, due to changing economic conditions, the purchase of stock in savings and loans is not always attractive. In order to sell stock in the converted company, management frequently moved away from the savings and loan name and converted to savings banks. Savings banks have had no such stigma attached to them.

Savings Bank Regulation

In Ohio, savings banks are subject to supervision and regulation by the Division of Savings Banks. Supervision of a converted savings and loan association is not diminished as a result of the conversion. With the exception of changes in lending authorities and the QTL test, a savings bank in Ohio is subject to statutes and regulations that parallel those of the savings and loan associations. Additionally, a common examination staff is utilized by both divisions, which ensures regulatory continuity for the converted institution.

The Federal Deposit Insurance Corporation serves as the Federal agency responsible for ensuring that all the requirements of Federal laws and regulations are met. There is no reduction in enforcing the requirements of Federal law. The converted institution is efficiently regulated through the cooperative efforts of the FDIC and the State Division examining staffs.

Mutual Ownership of Savings Banks

The Division of Savings Banks holds to the traditional belief that depositors of mutual savings banks, aka members, are the owners of that company. As such, they are entitled to elect the directors of the company; to determine what the company's articles of incorporation and constitution are; and to determine what changes to the company's corporate structure should be, i.e., acquisitions, conversions, or mergers.

Unfortunately, the individual depositors/members of a mutual savings bank often are not aware of these responsibilities and do not actively participate in the affairs of their company. This is due, in part, to the common practice of their executing a blanket proxy for management at the time they open a deposit account. From that point on, management has the authority to take whatever actions are necessary to operate the company. The individual depositors/members can revoke their proxies at any meeting, but our experience shows that this rarely happens. Their inactivity leaves the overall operation of the company in the hands of the directorate and management.

It is necessary to put things in perspective, however. The individual depositors/members of a mutual savings bank have not been harmed by the current system. They earned interest on their deposit accounts and had the opportunity to borrow from their company. As a federally insured institution, their deposits were protected up to the limits established by the Savings Association Insurance Fund (SAIF). Additionally, as the net worth of the company grew, they were guaranteed a share of the profits in the event of its total liquidation.

MUTUAL-TO-STOCK CONVERSION ACTIVITY

Section 1161.111 of the Ohio Revised Code provides for the conversion of mutually owned savings banks to stock savings banks. In preparation for such conversions, Rule 1301:12–1–08, "Conversion from Mutual to Stock Form of Ownership," was promulgated and became effective concurrent with Chapter 1161. This rule basically established the procedural requirements for such conversions.

Ohio's first application for conversion from a mutual savings bank to a stock savings bank was received during the third quarter of 1993. This application involved the conversion of Heritage Savings Bank, Cincinnati, Ohio, and the simultaneous acquisition of the stock by Provident Bancorp., Cincinnati, Ohio. This transaction has been the subject of articles in both *The American Banker* and *The Wall Street Journal*. Unfortunately, these articles have not been totally accurate.

In preparation for this application, the applicants were advised that the Division would basically adhere to OTS regulations and guidelines relating to the conversion of a mutual thrift company to a stock thrift company and that the Division would require full disclosures of the transaction to Heritage's members in order for them to vote upon the plan of conversion. The applicants were advised, however, that the Division would be flexible in applying OTS standards provided any deviations from existing standards were fully supported.

In evaluating a mutual-to-stock conversion, the division considers the following:

- All options available are fully disclosed to the depositors/members;
- A fair market value is established for the savings bank by means of an independent appraisal;
- All facets of the transaction, including benefits to the directors, officers, and employees, are adequately disclosed to the depositors/members;
- The depositors/members' subscription rights are not diminished as a result of the benefits to the directors, officers, and employees;
- No unreasonable benefits accrue to either the directors or management;
- The company can afford the transaction and any corresponding benefits for its directors, officers, and employees;
- The transaction will not negatively impact upon the overall safety and soundness of the converted company; and
- New revocable proxies are solicited from each depositor/member. Existing, continuing proxies are not permitted to be used for any kind of conversion.

Provided that all of these concerns have been addressed, the application is conditionally approved subject to action by the depositors/members.

Upon thorough evaluation of the Heritage transaction, we determined that each of these concerns was adequately addressed.

SUMMARY DISCUSSION

Based upon Ohio's experiences, I believe the proposed statute and mandatory rule-making is overkill and tends to ignore the overall record of supervision of the respective States. It is recognized that mutual-to-stock conversions are currently taking place at an accelerated pace. The motive of Ohio's mutuals is primarily to provide more flexibility in meeting net worth requirements without the forced sale or takeover of the institution. As a result of recent earnings performance, a window of opportunity exists which enhances a company's ability to raise capital (i.e., sell stock). However, I believe this window may be short lived.

I believe that undue attention has been focused upon mutual savings banks as opposed to mutual savings and loans. In Ohio, mutual savings and loan associations are not converting to State chartered savings banks merely to avoid Federal oversight or to provide significant benefits to directors, officers, and employees at the expense of the depositors/members.

Too much reliance is being placed upon OTS regulations and guidelines. Of particular concern are OTS requirements that individual depositors/members subscription rights are subordinate to the subscription rights of both tax qualified employee stock benefit plans and non-tax qualified employee stock benefit plans. The Ohio rules treat all entities equally.

Ohio's sole application by a mutual savings bank to convert to a stock savings bank provided all depositors/members full access to the projected pro forma value

of the converted savings bank based upon an independent valuation or appraisal. Any additional compensation or benefits were provided by the acquiring holding company or from restricted holding company stock accounts and were on par with the benefits provided to all other directors, officers, and employees of the holding company.

In closing, I believe that it is appropriate to restate those areas which should be considered in a mutual-to-stock conversion:

- All options available are fully disclosed to the depositors/members;
- A fair market value is established for the savings bank by means of an independent appraisal;
- All facets of the transaction, including benefits to the directors, officers, and employees, are adequately disclosed to the depositors/members;
- The depositors/members' subscription rights are not diminished as a result of the benefits to the directors, officers, and employees;
- No unreasonable benefits accrue to either the directors or management;
- The company can afford the transaction and any corresponding benefits for its directors, officers, and employees;
- The transaction will not negatively impact upon the overall safety and soundness of the converted company; and
- New revocable proxies are solicited from each depositor/member. Existing, continuing proxies are not permitted to be used for any kind of conversion.

By keeping these items in proper perspective, we, as regulators, can ensure that the transaction is fair to all depositors/members, is in the best interest of the company, and that the depositors/members have good information on which to base their decisions.

There are two issues of significance which must be included in this testimony. First, it must be noted that the Federal Deposit Insurance Corporation has issued a *Proposed Statement of Policy on Mutual-to-Stock Conversions* that is still open for comment. This is an excellent statement! It speaks correctly to the concerns, and it provides proper and adequate regulations to cover the event of conversion from mutual-to-stock thrift charters. It is my intention to inform FDIC of my concurrence with their proposed statement of policy. I think that the enactment of their statement and the enforcement of their rules will make unnecessary the enactment of either S. 1801 or H.R. 3615.

It must also be noted that the American Council of State Savings Supervisors, of which I am Chairman-elect, is an organization of my counterparts in numerous States. ACSSS, as it is called, is actively involved in the drafting of a set of model rules for converting charters from mutual to stock. The draft is being done to help the several States to adopt a somewhat uniform, conservative, and workable set of regulations. These will serve to compliment the position being taken by FDIC.

Because the introduction of S. 1801 and H.R. 3615 have put mutual-to-stock conversions up in the air, I urge the committee to resolve this issue as soon as possible so that those companies needing access to capital markets can take advantage of the existing window of opportunity.

I appreciate the opportunity to present my views to you today. I would be happy to answer any questions you have at the appropriate time.

ATTACHMENT #1

OHIO REVISED CODE

1161.111 Conversion to stock form

A savings bank without permanent stock may convert itself to the stock form, subject to the rules of the superintendent of savings banks. The superintendent shall adopt rules governing such conversions, but prior to the adoption of the rules, a savings bank without stock may convert to the permanent stock form with the prior approval of the superintendent.

HISTORY: 1991 H 397, eff. 10-23-91

PRACTICE AND STUDY AIDS

Baldwin's Ohio Legislative Service, 1991 Laws of Ohio, H 397—LSC Analysis, p 5-425

CROSS REFERENCES

Conversion from mutual to stock form of ownership, OAC 1301:12-1-08

1301:12-1-08 Conversion from mutual to stock form of ownership

(A) In order to convert from a mutual to a permanent stock form of ownership, a savings bank must file an application in accordance with this rule and receive prior written approval thereof from the superintendent.

(B) The application for conversion shall include:

(1) A plan of conversion;

(2) Amendments to the savings bank's articles of incorporation and a check payable to the secretary of state for the applicable filing fee;

(3) Amendments to the savings bank's institution and bylaws;

(4) A copy of the proxy and soliciting materials to be used; and

(5) Other information as the superintendent may require.

(C) The plan of conversion shall provide:

(1) A comprehensive description of the nontransferable subscription rights received by each eligible accountholder, including details on oversubscriptions;

(2) That the shares of the converting savings bank be offered to persons with subscription rights and management, in that order, and that any remaining shares shall be sold either in a public offering through an underwriter or directly by the converting savings bank in a direct community offering;

(3) That a direct community offering by the converting savings bank shall give a preference to natural persons residing in the counties in which the savings bank has an office;

(4) That the sale price of the shares of capital stock to be sold in the conversion shall be a uniform price determined in accordance with paragraph (I) of this rule, and shall specify the underwriting and/or other marketing arrangements to be made;

(5) That the conversion must be completed within twenty-four months from the date the savings bank members approve the plan of conversion;

(6) That each savings accountholder of the converting savings bank shall receive, without payment, a withdrawable savings account or accounts in the converted savings bank equal in withdrawable amount to the withdrawal value of such accountholder's savings account or accounts in the converting savings bank;

(7) For an eligibility record date;

(8) That the expenses incurred in the conversion shall be reasonable;

(9) That the converting savings bank shall not loan funds or otherwise extend credit to any person to purchase the capital stock of the savings bank;

(10) That the proxies held with respect to voting rights in the savings bank will not be voted regarding the conversion, and that new proxies will be solicited for voting on the proposed plan of conversion;

(11) The amount of the deposit of an accountholder shall be the total of the deposit balances in the accountholder's savings accounts in the converting savings bank as of the close of business on the eligibility record date. The plan of conversion may provide that total deposit balances of less than fifty dollars (or any lesser amounts) shall not be considered for purposes of paragraph (C)(6) of this rule; and

(12) That for a period of one year after the date of the conversion, no converted savings bank shall repurchase any of its capital stock if the effect thereof would cause the savings bank to not meet its capital requirements.

(D) A plan of conversion shall be adopted by not less than two-thirds of the savings bank's board of directors.

(E) Upon determining that an application for conversion is properly executed and is not materially incomplete, the superintendent will advise the savings bank, in writing, to publish a notice of the filing of the application. Promptly after receipt of the advice, the savings bank shall prominently post the notice in each of its offices and publish the notice in a newspaper printed in the English language and having general circulation in each community in which an office of the savings bank is located, as follows:

Notice of filing of an application for permission to convert to a stock savings bank

Notice is hereby given that, pursuant to section 1161.111 of the Revised Code _____ has filed an application with the Ohio division of savings banks requesting approval to convert to an Ohio-chartered permanent stock savings bank. The proposed plan of conversion will be available for inspection by any member of the savings bank at the offices of the division of savings banks in Columbus, Ohio, and at each office of the savings bank. Materials supporting the objections from any member of the savings bank or aggrieved person will be considered by the division of savings banks if filed within ten business days after the date of this notice.

(F) Promptly after publication of the notice or notices prescribed in paragraph (E) of this rule, the savings bank shall file one copy of the notice together with an affidavit of publication from each publisher with the superintendent.

(G) Following approval of the application for conversion by the superintendent, the plan of conversion shall be submitted to the members at an annual or special meeting and the plan shall be approved, in person or by proxy, by at least a majority of the total outstanding votes of the members of the savings bank.

(H) No offer to sell securities of a savings bank pursuant to a plan of conversion may be made prior to superintendent approval of the:

(1) Application for conversion;

(2) Proxy statement; and

(3) Offering circular.

(I) If the offering is to commence prior to the meeting of the savings bank members held to vote on the plan of conversion, the proxy statement and preliminary offering circular authorized for use by the superintendent shall set forth the estimated price range.

(1) The maximum of such price range should normally be no more than fifty dollars per share or fifteen per cent above the average of the minimum and maximum of such price range.

(2) The minimum of such price range should normally be no less than five dollars per share or no more than fifteen per cent below such average.

(3) No representation may be made in any manner that the superintendent has approved such price information.

(J) Within forty-five days:

(1) Of the date of the mailing of the subscription form, the subscription rights must be exercised.

(2) After the last day of the subscription period, the sale of all shares of capital stock of the converting savings bank to be made under the plan of conversion, including any sale in a public offering or direct community marketing, shall be completed.

(K) The converting savings bank shall pay interest at not less than the passbook rate on all amounts paid in cash or by check or money order to the savings bank to purchase shares of capital stock in the subscription offering or direct community offering from the date payment is received by the savings bank until the conversion is completed or terminated.

(L) For the purpose of this rule:

(1) The public offering shall be deemed to commence upon the filing with the superintendent of the preliminary offering circular for the public offering; and

(2) The direct community offering shall be deemed to commence upon the declaration of effectiveness by the superintendent of the final offering circular.

(M) The superintendent may grant a written waiver from any requirement of this rule.

(N) For purposes of this rule:

(1) The term "control" means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(2) The term "person" includes an individual, a group acting in concert, a corporation, a partnership, a savings bank, a trust, any unincorporated organization, or a government or political subdivision thereof.

HISTORY: Eff. 11-17-91 (1991-92 OMR 526)

CROSS REFERENCES

RC 1161.111, Conversion to stock form
RC 1163.24, Rulemaking powers

ATTACHMENT #3

Ohio Department of Commerce

George V. Voinovich, Governor

Division of Savings & Loans/Savings Banks
77 S. High St. • 21st Floor • Columbus, OH 43266-0512
(614) 466-3723 • FAX (614) 466-3594

Nancy S. Chiles, Director

November 18, 1993

Jack R. Wingate, Executive Vice President
Heritage Savings Bank
3316 Glenmore Avenue
Cincinnati, Ohio 45211

Leslie C. Nomeland, Senior Counsel
Provident Bancorp, Inc.
One East Fourth Street
Cincinnati, Ohio 45202

Gentlemen:

Pursuant to sections 1161.11 and 1161.78 of the Ohio Revised Code, the applications for Heritage Savings Bank (Heritage) to convert from a mutually organized savings bank to a permanent stock savings bank and to be simultaneously acquired by Provident Bancorp, Inc., (Bancorp) are hereby approved subject to the following conditions:

1. The conversion and acquisition shall conform in all material respects to the representations made by Heritage and Bancorp in the documentation submitted to the Division in the applications.

2. The Plan of Conversion shall be approved in person or by proxy by at least a majority of the total outstanding votes of the members of the savings bank.

3. In the event that Heritage is no longer deemed "well capitalized" as defined in 12 CFR 325.103(b)(1), or as such section may be hereafter amended, Bancorp shall immediately supplement Heritage's capital such that Heritage shall be deemed "well capitalized."

4. The establishment and maintenance of the liquidation account(s) corresponding to Heritage's existing retained earnings shall be accounted for in accordance with the Federal Financial Institution Examination Council's Instructions for Preparation

of Reports of Condition and Income, as amended, and Generally Accepted Accounting Principles. Heritage shall submit the accounting with appropriate explanation and footnotes to the Division for review and approval within 14 business days after consummation of the transaction.

5. Heritage shall submit copies of the approvals of the appropriate federal agencies to the Division.

6. Heritage shall submit, on Division forms, originally executed Articles of Incorporation, Constitution, and Bylaws to the Division.

7. Heritage shall submit copies of the minutes of the members' meeting and the report of the inspectors of the election to the Division.

8. In the event that the subscription offering is undersubscribed, Bancorp will contribute capital in addition to the net proceeds of the subscription offering up to the total appraised value of Heritage minus any discount on the subscription shares sold and expenses incurred.

9. Within thirty business days after consummation of the transaction, Bancorp shall provide the Division, in tabular form, a list of all eligible subscribers and their respective subscription requests. In conjunction with the foregoing list, Bancorp will submit to the Division, a list of all new Bancorp shareholders arising from the offering.

Should you have any questions regarding this approval, please feel free to contact the Division.

Yours very truly,

William J. Drumm

William J. Drumm, Superintendent
Division of Savings Banks

WJD:jlb:rly

cc: Federal Reserve Bank of Cleveland
Federal Deposit Insurance Corporation

PREPARED STATEMENT OF DAVID E. A. CARSON

CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, PEOPLE'S BANK

ON BEHALF OF

SAVINGS & COMMUNITY BANKERS OF AMERICA

Mr. Chairman, Members of the committee, my name is David Carson. I appreciate the opportunity to appear today on behalf of Savings & Community Bankers of America, of which I am First Vice Chairman, to testify regarding S. 1801, the Mutual Depository Institution Conversion Protection Act of 1994, which you, Mr. Chairman, and Senator D'Amato introduced on January 26, 1994. I believe we have responded, either in this statement or the attached appendix, to all the questions you posed in your letter of invitation.

By way of background, I am the Chairman, President, and CEO of People's Bank, a $6.4 billion savings bank located in Bridgeport, Connecticut. People's is organized as a mutual holding company, a corporate format we adopted in 1988 in accordance with the law of our chartering authority, the State of Connecticut. The conversion was consistent with the current rules in this area of the Office of Thrift Supervision. Our institution is insured by the Bank Insurance Fund of the Federal Deposit Insurance Corporation and the FDIC is our primary Federal regulator.

S. 1801 would specify that all mutual savings institutions would be required, should they elect to convert to the stock form, to do so in accordance with regulations of the OTS, unless, in the case of State institutions, State rules were more restrictive. At present, the OTS conversion rules do not apply to mutuals which have the FDIC as their primary Federal regulator. The bill also would specify that insiders of converting companies could receive no financial benefits in connection with the conversion beyond what they would be entitled to in their capacity as depositors. Further, institutions would be unable for 1 year after a conversion to propose to shareholders an increase in the direct or indirect compensation of any officer, director, or employee beyond the level of such compensation prior to the date of the conversion. Our understanding is that the bill, which would be effective retroactive to its introduction date, reflects concerns over how conversions are effected under State law and over insider benefits generally.

SCBA believes that the mutual-to-stock conversion area is one best suited for regulatory rather than legislative action. Conversion is a complex process with respect to which the OTS, in particular, has developed a great deal of expertise since 1974. Our understanding is that the OTS is completely willing to provide the FDIC with whatever assistance and counsel is needed to address conversions by State nonmember banks. We strongly urge you to refrain from proceeding further with legislation in this area and permit the agencies to arrange a regulatory framework that appropriately addresses Congressional concerns.

In this regard, SCBA has been greatly encouraged by the recent issuance by the FDIC of an interim regulation that asserts clear regulatory jurisdiction over conversions by its mutual regulatees to stock form. Such jurisdiction is entirely proper and fully consistent with the paramount importance of capital within the scheme of regulation of depository institutions mandated by Congress; it is difficult to imagine a set of corporate transactions more relevant to a regulator's safety and soundness concerns than those associated with a mutual-to-stock conversion and the prudent deployment of the capital it raises.

Effective February 15, 1994, such conversions are subject to a detailed and thorough FDIC approval process. According to the preamble to the rule, "the FDIC generally expects proposed conversions to substantially satisfy the standards found in the mutual-to-stock regulations of the OTS. Any variation from these regulations will be closely scrutinized. Compliance with OTS requirements will not, however, necessarily be sufficient for FDIC regulatory purposes." Among the areas to which the agency will devote special attention are the—

- adequacy of disclosure materials;
- compensation and other remuneration to be received by insiders;
- adequacy and independence of the valuation appraisal; and
- pricing of the stock.

Chairman Hove has stated that the FDIC and OTS staff will work together to establish proper criteria for conversion evaluations that satisfy both agencies.

In the past, we have proposed that the FDIC, rather than preempt State law entirely in this area, undertake an examination of State law regimes and permit those that are substantially similar to the OTS standard to continue in force. If a State framework met the standards, conversions could proceed under the State aegis. Otherwise, they would have to be processed by the FDIC under its regulations. This

would be less intrusive than a total preemption, leaving room for accommodation to legitimate variations in practice desired by State legislators and regulators. The application approach of the interim rule appears calculated to allow for such accommodation.

SCBA has urged the FDIC on a number of occasions to issue rules governing conversions by its regulatees and is very pleased that the interim rule essentially will track OTS practice. The conversion framework developed by the OTS is one that has served affected savings institutions, their members and their communities very well for almost 20 years. It was developed in the light of considerable Congressional interest and scrutiny and has been upheld by the courts as consistent with depositor rights. See e.g. *Ordower v. Office of Thrift Supervision,* 999 F.2d 1183 (7th Cir. 1992); *York v. Federal Home Loan Bank Board,* 624 F.2d 495 (4th Cir. 1980); and cases cited. Some 1,030 mutual institutions have converted to stock form using the OTS rules, bringing those companies some $16 billion in outside capital. These funds have served as a major systemic shock absorber against losses and protection for the taxpayers in addition to enabling companies prudently to expand the banking services they provide their communities. Let me stress that such benefits have flowed as well from the billions of dollars in capital raised in the numerous conversions by savings banks occurring over the years outside OTS jurisdiction under applicable State law.

SCBA regards the availability of a stable, effective, legal framework for conversions as a goal of the utmost importance. At present some 1,240 savings institutions with some $231 billion in assets are in the mutual form. Mutual institutions have proved over the years to be conservative, community-oriented companies that, because of their form of organization, are well able to adopt a long-range approach to their businesses. At present, they have lower non-interest expense ratios than their stock peers (2.30 percent versus 2.50 percent), higher tier-one capital (17.71 percent against 12.44 percent), and a better return on assets (0.84 percent versus 0.68 percent). A great many mutuals wish to remain in mutual form. Clearly, they will continue to be an important and vital presence in the financial system.

Nevertheless, mutuals essentially are able to raise capital only through earnings, and, if one thing is clear in the aftermath of FIRREA and FDICIA, it is that Congress has decreed that, for depository institutions, "capital is king." The ready access to additional capital offered by conversion to the stock form thus is an essential option for mutual companies seeking outside funds to protect against losses and to permit prudent expansion of operations to better serve their communities with home and other lending and deposit services. One simply cannot overestimate the importance of capital in the current, rapidly changing competitive environment, characterized, as it is, by dissolution of traditional geographic and product-line barriers, and severe pressures from such relatively unregulated competitors as mutual funds.

Despite its manifest importance, of course, capital is not only an end in itself but a means to an end. For capital to permit institutions to achieve the goals outlined here, it must be intelligently deployed. The OTS has been well aware of the need for proper planning for the use of conversion proceeds, and insists that converting institutions provide it with a business plan showing the use to which the new capital will be put. SCBA believes the agency has administered its regulatory requirements in this area in a serious and appropriate manner. The FDIC publicly has noted the great importance of this facet of conversion regulation and we are confident it will be a prominent part of the Corporation's regulatory regime.

Through the supervisory and examinations process, regulators properly ensure that institutions are neither under-capitalized nor over-capitalized. They can and should ascertain the soundness of the bank's strategic vision and the adequacy of the resources it brings to the challenge of utilizing capital—whether for improved delivery of services, for product or geographic expansion or for acquisitions. Such factors as human resources, technology, and internal controls are part of the regulators' regular examination and supervision process and they are equally applicable to the regulatory appraisal of an application for conversion from mutual-to-stock form.

Notwithstanding the very real benefits which the OTS approach to conversion has offered over the years, it has been subject to some criticism as not being sufficiently generous to depositors. Making the incorrect assumption that depositors are owners of a mutual institution in the sense that shareholders are owners of a stock institution, it has been suggested that conversions should result simply in distributing stock to depositors, instead of giving them rights to purchase shares in the initial public offering.

The Federal Home Loan Bank Board, the OTS's predecessor agency, long ago rejected this approach as misconstruing the rights of depositors, who are in actuality creditors to whom applicable law may accord a varying role in corporate governance

and rights to receive any surplus in the event of a liquidation. To make depositors recipients, through free distribution of stock, of the market value of converting institutions would be to provide them with an unbargained for windfall for which they have undertaken no risk, and would add nothing to the capital position of the company. The Bank Board also was concerned that the availability of such windfalls would have a disruptive and destabilizing effect on the entire mutual segment of the industry—as, we believe, would related schemes such as cash distributions or saleable stock subscription rights.

The FHLBB correctly determined that, from a public policy standpoint, the primary objective of the conversion process should be to produce a stronger depository better positioned to provide the home lending and other community banking services it was chartered to deliver, making equitable provision for those depositors wishing to become shareholders to participate on a priority basis in the initial public offering, and for all depositors' liquidation rights. As noted, this regulatory framework has been uniformly upheld by reviewing courts.

There also has been some criticism of the OTS rules for permitting use in conversion votes of running proxies. SCBA believes such criticism misunderstands the reality of the conversion rules' requirements. Prior to the vote on a plan of conversion, OTS requires each member to be provided detailed disclosures of what the conversion involves, including the depositors' subscription rights, as well as with balloting material that the accountholder may use to vote yes or no on the conversion (assuming he or she does not wish to appear in person). The depositor is given the material 20 to 45 days before the meeting and is informed that if he or she fails to vote, the board of directors will exercise any extant running proxy in favor of the conversion. This approach, in our view, gives a depositor ample opportunity to exercise his or her franchise with regard to the question of whether a conversion should take place. Forcing institutions to give up use of running proxies in this context simply would be to compel companies needlessly to invest money and time trying to induce indifferent depositors to vote on the conversion. There is no rational reason for such a step.

Recently, SCBA has heard suggestions that the Federal Government, in effect, should be able to benefit financially from conversion transactions through giving itself saleable stock subscription rights, free stock options or simply claiming part of the proceeds. The reasoning goes that such a levy would be justified because of mutuals' unconventional ownership status and the benefit of Federal deposit insurance.

SCBA fails to see how the absence of shareholders opens an entity to having some of its capital seized by the Federal Government. Will foundations, charities, private universities, credit unions, and mutual insurance companies be targeted next?

As for the deposit insurance argument, it would be completely unjustifiable to target one small segment of the universe of insured institutions for an extra premium—mutual savings institutions benefit no more from deposit insurance than do mutual credit unions or stock form depositories. Moreover, the imposition of a deposit insurance surcharge on transactions that, by raising extra capital, would better protect the SAIF or BIF would be counterproductive and highly illogical, in our view. Bear in mind, as well, that mutuals that are insured by SAIF already face many years of extremely high premiums because of the need to recapitalize SAIF while simultaneously paying the FICO bonding expense; the competitive disadvantage that SAIF institutions will face once BIF recapitalization occurs and BIF premiums become dramatically lower than those of SAIF is a serious problem that will require a legislative solution.

SCBA must emphasize very strongly that, under the U.S. Constitution, private property is not freely available for the Government to convert to its own use. The revenue raising proposals in question here very squarely raise the issue of compensable takings. See *Webb's Fabulous Pharmacies v. Beckwith,* 449 U.S. 155 (1980).

Putting aside the question of constitutionality, however, SCBA believes it would be very bad public policy to embark upon a course, in effect, of taxing the capital of converting savings institution. This would be a very sharp departure from traditional tax policy, which has taxed the gain on the appreciation realized in the sale of assets, but has not sanctioned direct levies on capital itself. Again, the existence of Federal deposit insurance offers no justification for such a step; there certainly would be no suitable rationale for taxing the capital of mutual savings institutions unless such treatment extended to all insured depository institutions, including credit unions, as well as to other private entities benefitting from Federal guarantees, such as Fannie Mae and Freddie Mac.

Taxation of this sort could have a serious effect on the capital markets generally, once investors assimilated the knowledge that the Federal Government had determined to begin skimming funds raised in initial public offerings (IPOs). Concerns

about how far a revenue-hungry Government would go would have an adverse effect on investor confidence and the orderliness of the capital markets, with unpredictable negative consequences for the ability of corporations to raise funds.

The experiences of the savings institutions and banking industries in recent years have starkly underlined the important of strong capital. The proper course for the Government is to encourage companies to establish and maintain strong capital bases capable of supporting enhanced community banking services and guarding against losses, not opportunistically to view institutions' capital as a revenue source.

The retroactive nature of S. 1801 and an earlier House bill on conversion, H.R. 3615, have had a disruptive and confusing effect on the conversion process. Generally, retroactive legislation, in our view, is an undesirable method of proceeding, and typically raises constitutional questions. Given the well-established nature of the OTS treatment of insider benefits, we ask that you consider clarifying that conversions may go forward provided that OTS standards in this area are observed. In addition, we strongly urge you to publicly endorse a practical and equitable approach to grandfathering transactions that were substantially underway as of January 26, 1994; approval by an institution's board or trustees of a plan of conversion would be a reasonable benchmark.

As a final matter, Mr. Chairman, I wish to comment on the current trend toward conversion by OTS-regulated savings associations to savings banks subject to the primary Federal jurisdiction of the FDIC. Some 186 such conversions have occurred since enactment of FIRREA.

The dominant impulse behind this trend often has been mischaracterized—first, as a desire to obtain broader investment authority, and, currently, as only reflecting an interest in converting to stock form under State rules more liberal than those of the OTS. The liberal investment hypothesis is disproved by the fact that when Federal regulators lifted the moratorium on such conversions after limiting converted companies to exercising only the same powers they enjoyed under OTS rules, a very large number of companies nevertheless exercised that option. While I suspect some companies have converted to take advantage of State mutual-to-stock regulations, there have been too many exits by stock savings institutions and by institutions in States that utilize the OTS framework, such as Illinois, to assume that this has been a dominant objective. SCBA is convinced that the primary objective is to avoid OTS examination costs and the annual assessment levied by OTS on its regulatees to pay for its operations; for a $100 million institution, the assessment would amount to about $16,000 (and examinations of holding companies and affiliates can be even more costly). As you know, many commercial banks over the years similarly have avoided national bank charters and accompanying examination fees and assessments by the Office of the Comptroller of the Currency.

Mr. Chairman, this concludes my prepared remarks, and I will be happy to answer any questions you may have.

APPENDIX

Q.1. Who owns a mutual institution?

A.1. There is no single answer to this question, although it is clear that depositors' "ownership" rights fall short of what one normally associates with that term. The following excerpts from three court decisions typify judicial analysis in this area. Bear in mind as well that, in some States, savings bank depositors under State statutes do not even have the right to exercise a vote in corporate decision making.

- "The mutual form of organization is an odd duck. Nominally, the customers own the mutual, but it is ownership in name only. They cannot share what they "own," and if they withdraw savings they receive only the nominal value of the account rather than a portion of the mutual's net worth, which is valuable to them only to the extent it permits the bank to pay higher interest. . . . A depositor's interest in a mutual S&L is a liquidation preference, not a transferable right. . . ." *Ordower v. Office of Thrift Supervision*, 999 F.2d 1183, 1185, 1187 (7th Cir. 1992).
- "Significant characteristics of ownership are missing in the mutual context. The depositors in a mutual institution have no legal title to the surplus of the institution and do not share in any risk of loss since their deposits are insured. The only "vested" interest a depositor has in the mutual institution is in the depositor's funds on account. These rights or interests remain unchanged in a conversion. . . . A depositor's interest in a pro rata distribution of the bank's surplus is a mere contingency and cannot be realized unless the bank liquidates while solvent; an unlikely event. Plaintiffs are not entitled to receive cash or free stock for an interest that hardly rises to the level of an expectancy. The depositors' contingent claims to a distribution of surplus were adequately protected and preserved by the

liquidation account set up as part of the . . . conversion." *Lovell v. The One Bankcorp,* 614 A.2d 56, 67 (Me. 1992).

- "While it is indisputable that the depositors are the "owners' of the equity in a mutual savings bank . . . this ownership interest is severely limited, and does not amount . . . to an interest commensurate with the common, everyday experience of "ownership." The depositors are essentially the creditors of the institution, entitled only to protection upon conversion to the extent of the amount of their accounts, which continue in the new institution. . . . There is no merit to plaintiffs' claims that their "ownership" rights entitle them to a share of the bank's assets, or to a guaranteed profit upon conversion." *In the Matter of East New York Savings Bank Depositors Litigation,* 145 Misc.2d 620, 623; 547 N.Y.S.2d 497, 500 (1989).

Q.2&3. What parties, if any, should receive priority rights in a conversion? To what extent should management and insiders be allowed to participate in a conversion? Should they receive preference over depositors?

A.2&3. SCBA believes the approach to priority rights contained in the OTS rules is an eminently sensible one. Depositors stand first in line (unless there is an employee stock ownership plan (ESOP), which is subject to a 10 percent of shares limit) followed by directors management and employees, then investors from the community (if the community offering option is exercised), then the general public—all subject to a concentration limit that prevents any person from acquiring more than 5 percent of the converted institutions' shares. Allowing management and other insiders to purchase stock on a priority basis makes a great deal of sense, in our view. These are precisely the people who should be encouraged to take an equity stake in the company, and we see no public policy reason against giving them a priority purchase right *vis a vis* purchasers other than depositors. Note that OTS rules make the management purchase priority totally subject to that of depositors; the ability of management, under OTS rules, to buy 25 percent to 35 percent of the initial public offering (IPO) (depending on the institution's size) represents an aggregate ceiling on acquisition, rather than as an absolute reservation of a tranche of the offering for officers and directors. With regard to whether insiders ever should be able to have a purchase priority relative to depositors, while we believe the OTS approach is reasonable, it basically originated in and reflects the legal relationship of depositors in Federal mutual savings and loans to their institutions. In the case of State savings banks, however, in States such as Massachusetts, this relationship is more attenuated than in the case of Federal associations, with depositors having no role in corporate governance, for example. An approach that is sensible and proper in one case, therefore, will not necessarily be so in another.

Q.4. How effective is the current approval process in ensuring that the stock is priced at fair market value?

A.4. Often there is a considerable increase in the price of a converted institution's stock immediately after the IPO, and some have suggested that this indicates there is something wrong with the appraisal process. Pricing a company for an IPO is not an absolute science, and it is true that within the range of what is determined to be a reasonable valuation of the institution, there is a tendency to pick a point that will allow for some post IPO buoyancy to benefit stockholders and develop an early market in the stock. Our impression is that the OTS and the other regulators do a good job of administering the process to guard against the potential for abuse. The very favorable stock market in recent years has treated many IPOs with bursts of optimism, not just financial institution issues. This is an artifact of market psychology, in our view, and does not reflect a flaw in the conversion process.

Q.5. Do sufficient safeguards exist to ensure that the conversion proceeds are utilized productively?

A.5. The OTS in our view has been quite properly concerned that conversion proceeds be utilized in a safe, sound, and productive manner, and insists that converting companies provide it with a business plan showing the use to which the new capital will be put. Our impression is they take this aspect of the conversion process very seriously. The FDIC publicly has noted the great importance of this facet of conversion and we are confident it will be a prominent part of their regulatory regime in this area.

Q.6. What issues are raised by merger conversion, and how should such proposals be evaluated?

A.6. As originally devised by the FHLBB, under close Congressional scrutiny, conversions were designed to let mutual institutions adopt the stock form as a way to attract capital to better carry out the mission for which they were chartered. State regimes for savings banks basically have proceeded from the same impulse. Merger conversions, available at first only in supervisory cases, are entirely different arrangements, involving the disappearance of the mutual and its net worth into a

stock form bank or thrift. Depositors are allowed to buy the stock of the acquirer at a discount (OTS rules allow up to a 5 percent discount, and some States more). At present, OTS has placed a moratorium on merger conversion, but the FDIC has not. Given the concerns and controversy generated by merger conversions, and their fundamentally different nature from standard conversions, SCBA does not oppose a regulatory pause to evaluate and, if appropriate, readjust the rules governing these transactions.

PREPARED STATEMENT OF CHRIS LEWIS

Director of Banking and Housing Policy, Consumer Federation of America

The Consumer Federation of America appreciates the opportunity to testify before the committee on insider abuse in the conversion of mutual savings institutions to stock-owned financial corporations and on S. 1801, the "Mutual Depository Institution Protection Act of 1994."

Insiders have never been timid about converting federally insured financial institutions into personal playpens for themselves and their friends. It is a recurring theme that shows up repeatedly in examination reports of the regulatory agencies and in the ashes of failed institutions of all classes.

But, the Gold Medal for Insider Chutzpa and greed must go to the current gang of conversion artists at work on the Nation's mutual savings institutions.

Mr. Chairman, this committee performed a valuable and lasting public service over the last few years by reforming the regulation of the savings and loan industry and putting and end to the high-flying schemes that drained deposit insurance funds and the U.S. Treasury in the last decade.

But, today's hearing demonstrates that the job is not yet complete.

One area of abuse—the conversion of mutual institutions into stock companies—was left untouched by the reforms and this oversight—however accidental—has turned into a wonderful, fur-lined play pen for S&L insiders, conversion law firms and stock manipulating Wall Street fast-buck artists.

Most, if not all, of this activity is perfectly legal because Congress, the State legislatures and their various regulatory agencies have failed to adequately deal with the problem—and have left a mish-mash of weak and conflicting rules on the books that have provided a welcome mat for the sharp deal makers. Fair play has often gone out the window in this massive "Conversion Lotto" with all the odds—and the winnings—in favor of the insider.

As the chief executive of one Federal savings institution has said: "We are in the middle of a feeding frenzy."

The conversion mania has produced windfalls for the management and directors—the insiders—at many of these institutions and has allowed stock companies to seize institutions at bargain-basement prices. It has been a wonderful game for the lawyers, the securities firms and the insiders.

Rut, surely, Mr. Chairman, it is no way to build a financial system.

In most cases, the depositors—the owners of these mutual companies—get the crumbs—whatever the insiders drop from their overloaded plates.

Principle Concerns

Today much of the concern centers around merger conversions and it is this activity that has spawned the headlines about "feeding frenzies" and resulting abuses.

We identify four principle areas of abuse or potential for abuse regarding merger-conversions and stand alone conversions:

1. Insiders obtaining control of institutions through conversions;
2. Unfair and excessive "deals" offered "insiders" to induce officers and directors to push for conversions without regard to the best interests of depositors or the community;
3. Fraudulent low appraisals of institutions involved in the transactions, letting holding companies obtain mutuals at bargain basement prices; and,
4. Limitation of meaningful participation of account holders the real owners—in the transactions.

There is also concern that the "big deals" and the stories of lucrative pay-offs to officers and directors—as well as discounted stock arrangements for depositors—will ultimately create that "irresistible urge" for other mutuals to leap into the game.

We believe that this committee needs to look carefully at whether these artificially-induced urges are really good public policy or the right way to build a financial system—where the publicly-backed insurance funds is involved.

While OTS and FDIC feud about the issues, there are voices on the outside that have expressed concerns. An newsletter, the Thrift Regulator, quoted a Washington lawyer and conversion expert recently as warning:

"There are some States where management can buy so much stock before the depositors get in that the equity and fairness in the conversion process goes away."

GROWING PROBLEM

Whether regulators and Federal and State governments look on these issues as good, bad, or indifferent, no one can ignore the fact that something big has been going on in the conversion arena. Since FIRREA, scores of institutions have swapped Federal for State charters, almost 300 mutuals have converted to stock companies and the average amount of stock sold per conversion has increased from $10 million in 1989 to some $32 million in 1993.

Underneath these numbers are case-histories that more dramatically point to the problems being generated by these merger conversions.

Let us remember that the owners of record of these institutions are the depositors—that is the definition of a mutual—of cooperative ownership.

But to watch these schemes in action, you would never recognize that fact. Perhaps no one says it better than Home Savings depositor Evelyn Surratt who testified before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance last month:

"I don't think the officers and directors are doing right by us members. It looks to me like they're looking out for themselves instead of us. They should treat the people right who stuck by them all these years, but their not. The statute book says we're the owners. I've seen it. It's plain. Anybody can understand it. I'll read it to you, 'Members are the owners of a mutual savings bank.' But they've got all these high-powered experts trying to tell us the law doesn't mean what it says. That's just not right. A lot of folks in Albermarle might not have a whole lot of education, but we're smart enough to know right from wrong."

Clearly, what the owners—the depositors—are getting in many of these conversions is nothing more than the crumbs from the table. Sitting at the big feast on the inside are the directors and officers who are wooed to grease the skids for the quick slide into stock companies or holding company acquisition.

Provident Bancorp's President, Allen Davis, who has been scouring the Midwest in search of mutuals willing to play the merger-conversion game is very blunt about why the Cincinnati Ohio-based holding company likes the game.

"We can virtually get the institution for relatively nominal amounts."

And the numbers published in the American Banker last November indicate that Mr. Davis is, indeed, the master of understatement.

The American Banker estimated that provident would be paying roughly $1.573 million to officers and depositors of Heritage Savings, an Ohio mutual with an appraised value of nearly $5.7 million—a more than three-fold windfall. From Ohio, to North Carolina, to Wisconsin to Florida these self-enrichment schemes abound.

In the polite worlds of banking, finance, and the stock market, the lucrative deals offered insiders are described as necessary "inducements" and proper payments to those that have "managed the institutions so well." Among the less polite and less sophisticated these look like just plain old bribes used to let someone—some corporate entity—make off with the goods while everyone looks the other way.

And one wild deal begets another wild deal. The disease spreads and ultimately the pressures become difficult to resist and conversions start moving whether or not it is the true desires of the management or the depositors. And deals move under theses pressures even when there are serious questions about what the schemes may mean to financial stability—and the safety of deposit insurance funds.

THE INSIDER'S OUTSIDE FRIENDS

Not only has the conversion mania created a new and aggressive breed of insiders, but it has spawned a sophisticated team of "outsiders" who roam the country opening accounts at mutual institutions in the hopes of cashing in on lucrative stock deals offered at discount prices in a conversion.

The New York Times says some of these operators have opened hundreds of accounts as a "relatively inexpensive way to get stock at low prices." Apparently, this band of "sophisticated outsiders" has sometimes created situations where depositors' demand for stock far outstripped the banks' ability to satisfy it.

At Home Savings Bank in Hollywood, FL, depositors and management submitted orders for $105 million of stock in late 1992, but the company was issuing only $24 million. Some of the requests for stock were in the form of buy orders for lots of a half million dollars each.

"An awful lot of people from New York City somehow found out and made deposits so they could buy the stock," an executive of the institution was quoted as saying.

SUPERVISION?

While these games have been underway, official Washington has been tardy in recognizing the seriousness of the problem—and has failed to come up with a workable policy that would insure fairness and end the windfall profit games of the insiders.

Congress authorized stock savings and loans in 1948, but failed to accompany that Act with mechanisms and guidelines for shifting the ownership when these cooperatively-owned entities were converted.

Through the years there have been stops and starts—including short-lived moratoriums—as Congress and the regulators grappled unsuccessfully with the problem.

In 1963, a Congressional report on mutual savings institutions sounded alarms, warning about the possibilities of "windfall profits accruing to a small group of insiders who initiate the conversion plan."

Now, 40 years later the "feeding frenzy" of conversions is underway big-time and the sharks are in the water. Unfortunately, the remedies on the table are tardy and many a windfall profit has already been swept into the pockets of the insiders.

Nonetheless, we commend the efforts that are underway. CFA does not pass out many plaudits for the Federal regulators, but we would be remiss if we did not note the vigorous leadership of Jonathan Fiechter at the Office of Thrift Supervision in this area.

Among the regulators, he has been out front aggressively for many months in attempting to control the frenzy. OTS imposed a moratorium on January 31 on merger-conversions—a gutsy action badly needed to provide time for the regulatory community and Congress to come up with workable and fair policy.

And, among the State regulators, the Superintendent of Banks of the State of New York, Derrick Cephas, is unequaled in his steadfast pursuit of fair play in the conversion market place.

Both of these men have done much in recent weeks to help restore the public's confidence in the integrity of public service.

But, the public and the regulators need Congress to act and to provide basic statutory guidelines that will control the conversions, prevent the windfall profits and give the depositor-owners a even break with the insiders.

The OTS needs help in the form of statutory across the board safeguards that will protect the depositors—the real owners—in these mutuals and the safety and soundness of the financial system—and prevent unfair, unearned windfalls from lining the pockets of the insiders. Unfortunately, many of the States and apparently OTS's sister agency—the Federal Deposit Insurance Corporation (FDIC)—as one trade publication noted last year appear "unfazed" by the concerns.

Some regard the issue as a "turf war" between the OTS and the FDIC—with the converted State savings banks added to the jurisdiction of the FDIC—and subtracted from the universe of institutions under the wing of the OTS. Turf wars being what they are in this town, there is undoubtedly a lot of truth in these assumptions.

But, we believe that the Congress should look past the bland assurances from the FDIC and not dismiss the OTS concerns out of hand. Turf wars aside, any casual glance at the financial landscape should be enough to alert this committee and the Congress to the fact that the rules of the conversion road are sadly deficient and horribly inconsistent from State to State.

RECOMMENDATIONS ON S. 1801

We believe that S. 1801—the "Mutual Depository Institution Protection Act of 1994"—introduced by Chairman Riegle and Senator D'Amato provides an excellent framework for statutory protections.

We are pleased that the legislation does not veto State conversion laws and allows States legislatures to enact additional protections for their citizens. Thus the hands of regulators like Mr. Cephas will not be tied and States will be able to enact laws to deal with specific situations and specific protections in their jurisdictions. The Federal law, as proposed by the Riegle-D'Amato bill would provide the basic statutory requirements for conversions with the States left free to act on stronger provisions.

S. 1801 properly limits the benefits of conversions provided any officer, director, or employee to those available to the person as depositor. If the insider is not a depositor, he or she may obtain stock under the same terms and amounts that are available to the general public.

The legislation also calls for a study by the Secretary of the Treasury on several issues including fairness of mutual stock conversions, the accuracy of appraisals and valuation techniques and the adequacy of disclosure to depositors and the general public.

We note that the study would not be submitted until a year after enactment of this legislation. We believe this is too long and we urge that the bill be amended to delete the year-long study and, in the alternative, that the regulators be required to adopt rules within 90 days of passage to provide guidelines on appraisals and valuation techniques and public disclosure. The regulators have these problems on the table already and most, if not all, the data is available without further study.

Mr. Chairman, the feeding frenzy is underway now and frankly remedies have been too long delayed already. Beyond the year for the study, there will be another extended period for drafting and adoption of either regulations or statutes to implement the findings of the study. Studies are fine and we have no objection to Treasury continuing to look at the problem—but studies are poor substitutes for action. And, this problem needs action without delay.

We believe that the bill could stand improvement in the area of disclosure and in proxy voting procedure.

One principal area of concern for CFA is the poor and often misleading disclosure given to mutual depositors of a proposed conversion to a stock company. Depositors are both misinformed by management about the nature and consequences of a conversion and provided woefully inadequate time and resources to respond to management recommendations for conversion.

The simple fact is that depositors are at an overwhelming disadvantage to appreciate the significance of and to respond to proxy statements that are written in incomprehensible legalize and often delivered in junk mail packaging.

Secondly, mutual insiders are often able to manipulate the voting on a conversion through the exercise of previously executed general proxies. We believe that the bill should include a prohibition on the exercise of general proxies for any conversion—i.e, only fresh proxies may be used to approve a conversion. A conversion is a death sentence for a mutual and every precaution should be taken to make certain that members willingly agree to shoot their own horse.

Finally, we do not underestimate the difficulties of apportioning the proceeds of a conversion among depositors, but we believe that the committee should consider that at least a portion of the windfall should be plowed back into the community in some form.

All of these institutions—insiders and depositors alike—have enjoyed the benefits of Federal deposit insurance backed by the full faith and credit of the taxpayers. This has been the glue that has held the industry—including mutuals—together during the good-times and the bad. It is also a fact that there have been losses to the insurance fund when mutuals have gone belly up.

Perhaps some of the funds—gained from windfall sale of stock—could be allocated to the Affordable Housing Program maintained by the Federal Home Loan Banks. In many of these cases, the mutual savings institutions undergoing conversion have borrowed at bargain-basement rates from the Home Loan Bank System. And, in all cases, the Home Loan Bank System and its loan windows have provided an important backup for all member institutions—whether or not discount loan windows were utilized. The Home Loan Bank System's Affordable Housing Program would seem a logical repository for the retained excess capital of mutual institutions undergoing a conversion.

Conclusion

CFA would like the committee to be aware of our general concerns about the loss of mutual institutions from the financial services marketplace. When organized effectively with depositor participation, mutual associations provide for a broad-based form of financial ownership, accountability to depositors and therefore to local communities.

However, mutual institutions have suffered greatly over the years by managers who have inadequately informed an association's members about their institution and by a Federal and State regulatory environment that has been critical—in word and deed—of the mutual form of organization.

The committee can do much to correct these trends and help revitalize mutual associations. Policies should be adopted to encourage and nurture mutual institutions. Mutually-owned institutions should not disappear from the financial scene in these high-flying schemes. Regulators should take steps to push mutuals toward true "depositor owned and controlled" institutions, not just collectors of proxies.

While the conversion issue may not be the biggest regulatory problem to come before this committee, it is clearly a prime exhibit for those pushing for a rational consolidation and coordination of regulatory policy and enforcement.

Not only do we have questions about conversions, but we have an exhibition of world-class leap-frogging between Federal regulatory agencies—and a budding feud that only confuses the regulatory issues.

One agency—OTS—sounds fire alarms about conversions while its sister agency—the FDIC—yawns and says don't worry we have plenty of fire trucks and fire fighters. And the agencies issue their pronouncements from separate marble palaces sitting right next to one another around the corner from the White House.

And then we have the States, some of which have added their own regulations to the mix—and some allowing what Forbes Magazine described as "bonanzas" for management and other insiders.

Congress needs to clean up this mess now—while there are still some mutuals left to serve local communities. The conversion game has been going on full tilt and if remedial action is delayed, the issue will be relegated to the graveyard of good ideas that Congress let die on the vine. For the depositor-owner ripped off while the insiders trotted off to the islands with the goods, next year is too late.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ANDREW C. HOVE, JR.

Q.1. Some individuals have contended that mutual form is inherently inferior to stock ownership form and that conversions should be encouraged as a matter of public policy. Should Federal policy endorse incentives that encourage conversions, particularly in the case of well-capitalized institutions?

A.1. The mutual form of ownership is not inherently inferior to the stock ownership form although as the insurer, the FDIC recognizes that stock ownership allows a quicker access to the capital markets which may be important for some institutions. However, we do not believe that incentives should be created simply to encourage conversions, especially for well-capitalized institutions. Institutions generally should convert only when there is a good business reason for doing so. Mutual institutions have operated successfully for many years, not only in thrift institutions but in other fields as well, such as insurance companies and credit unions. Not until 1980, 47 years after the creation of the Federal Deposit Insurance Corporation, was any deposit insurance loss incurred by the deposit insurance fund from a mutual institution. While it can be argued that shareholders can impose discipline on management that is lacking in the mutual form of ownership, Congress has given the FDIC sufficient authority to instill discipline within the system.

Q.2. Conversion plans must be approved by the account holders. In many instances, however, the account holders have already provided management with "running" proxies when the accounts were opened. While account holders may revoke these proxies, critics charge that the proxy system does not ensure an adequate role for the account holders. What, if any, changes do you suggest in this area?

A.2. We agree that the proxy system does not assure an adequate role for account holders. General, or running, proxies, signed when accounts were opened, often are outdated. In matters of significant importance to depositors, including a conversion to stock form, voting by specific proxy should be required.

We also point out that in some States there are situations where no depositor vote of any kind is required and the trustees are permitted to vote for conversions on behalf of the institutions. State laws permitting such nonparticipation should be encouraged to be changed or superseded by Federal law.

Q.3. OTS recently imposed a moratorium on merger conversions. What issues are raised by merger conversions, and how should such merger conversions be evaluated? Will the FDIC be imposing a similar moratorium?

A.3. Prohibition of merger conversions is not in the best interests of the deposit insurer because it potentially limits a major class of potential capital providers—many merger conversions have saved costs to the deposit insurance funds. We understand that the OTS rule excludes supervisory merger conversions from the moratorium. However, institutions needing capital, but which are not capital deficient to the extent of necessitating a supervisory conversion, should not be subject to a moratorium. Further, a moratorium on

merger conversions unnecessarily limits the options available to account holders wishing to convert. Merger conversions allow mutuals to participate directly in the consolidation now going on in the industry, but the transactions raise a number of issues similar to a standard conversion. Of paramount concern is whether the trustees have determined to enter into a merger conversion for remuneration above and beyond what would be obtainable for themselves in a standard conversion. Other issues include (1) the adequacy of the price paid by the acquirer; (2) whether a "control premium" should be factored into the purchase price; (3) whether account holders have received fair treatment relative to stock distribution; and (4) the amount account holders should receive if the form of a discount price on the conversion stock on some other currency. Thus, the question is not whether to permit merger conversions but to assure that the reasons for the transactions are sound and the value of the mutual is fairly distributed.

Q.4. S. 1801 requires converting institutions to wait 1 year before voting incentive compensation. This provision is designed to separate the decision to grant incentive compensation from the decision to convert to stock form and ensure that such compensation is awarded by the clear owners of the institution. What is your assessment of this provision of the bill?

A.4. The field of incentive compensation clearly needs to be reviewed and more closely supervised and regulated. The event of conversion should not be an opportunity to excessively increase management compensation but rather, any increases upon conversion should be reasonable compared with past levels of compensations. We believe incentive compensation can be an effective management tool but should not be determined and permitted until after conversion has occurred. The FDIC believes that the new owners should approve incentive arrangements for officers and directors. We do not believe the regulator needs to restrict the right of the new owners of a converted institution to recruit, retain, and adequately compensate the management team once the conversion has been completed. We support safeguards to prohibit incentive arrangements being agreed to prior to conversion that would become effective after the conversion; however, a 1-year time frame may be unnecessarily excessive.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM DERRICK D. CEPHAS

Q.1. In his testimony, Mr. Hove suggested a major overhaul of the conversion process, including the distribution of transferable stock purchase rights to all depositors. What is your assessment of this proposal?

A.1. In his testimony, Mr. Hove stated that there are major flaws in the existing conversion process. He stated that the economic value of the converting institution flows to those "who are wealthy enough, and knowledgeable enough, to stand in line to buy it." We agree that the existing process does not encourage participation by all depositors. Much can be done to make depositors who are willing and able to take the economic risk or investing in the converting institution more aware of the benefits of such investment. For

example, disclosures to depositors should be expanded and procedures for soliciting depositor subscriptions should provide more time for depositors to review and consider the materials provided to them and to bake investment decisions.

As to the specific proposal on transferable subscription rights, since depositors are not "owners" of a converting mutual institution, it is difficult to argue that they are entitled to receive the economic value of the institution. However, as I pointed out in my testimony, no one technically owns mutual institutions in New York, and so ultimately the question of who should receive the economic value is a political one. We believe that depositors should continue to be given first priority in subscribing for conversion stock. We also believe that a board of trustees, under the circumstances we have previously identified, should be permitted to distribute a portion of the economic value of the institution to the depositors in connection with a conversion.

A conversion process that favors the distribution of transferable subscription rights warrants further study. Any such study should include a full review of the effect of such policy on the rights of depositors as "owners" of a mutual institution. Numerous Federal and State courts have found that depositors have no property interest in the capital of a mutual institution. A regulatory policy which requires distribution of valuable rights to all depositors could lead to depositors' claims to distribution of the net worth of an institution. This could result in time-consuming and costly litigation for institutions considering conversion and also potentially for those who have already converted.

As Mr. Hove points out in his testimony, however, depositors do have rights to participate in a conversion. We believe that those rights should be meaningful, both with respect to depositors' right to vote for or against a conversion and to subscribe for the conversion stock.

Q.2. Some individuals have contended that mutual form is inherently inferior to stock ownership form and that conversions should be encouraged as a batter of public policy should Federal policy endorse incentives that encourage conversions, particularly in the case of well-capitalized institutions?

A.2. As I stated in my testimony, conversion from mutual-to-stock form is a legitimate business objective and has over the years allowed the thrift industry to raise billions of dollars of additional capital. It is important that conversion remain an available avenue for bringing new capital to the industry. Mutual institutions desiring to convert should be allowed to do so under a set of rules which balances in a fair and equitable manner the various competing interests present in the conversion context. We also firmly believe, however, that thrift institutions desiring to remain mutual should be allowed to do so.

Q.3. Conversion plans must be approved by the account holders. In many instances, however, the account holders have already provided management with "running" proxies when the accounts were opened. While account holders may revoke these proxies, critics charge that the proxy system does not ensure an adequate role for

the account holders. What, if any, changes do you suggest in this area?

A.3. We believe that management should not be permitted to vote "running" proxies in favor of a conversion. The depositors' vote on the conversion is often the only matter on which depositors are ever asked to vote. A conversion changes forever the corporate structure of a thrift institution and such a matter should not be decided by the use of "running proxies." Such use, in our view, is inconsistent with the duty to insure the exercise of a meaningful and informed franchise.

In New York, "running" proxies are not permissible for use by mutual savings banks. A converting institution must receive the affirmative vote of at least 75 percent of the deposits represented in person or by proxy at the special meeting of depositors. While there is no quorum requirement under New York law, the supermajority voting requirement assures that a substantial number of interested depositors vote in favor of the conversion. If a quorum requirement existed under New York law, converting institutions would be faced with the difficulty of soliciting enough proxies to constitute a quorum. In our experience, given the potentially large number of depositors in a converting institution, a quorum may be difficult to obtain.

Q.4. In most conversions, only a small minority of depositors purchase stock. Critics point out that many of these depositors are actually professional investors who maintain small accounts at numerous mutuals in hopes of cashing in on a conversion. Are there steps you would suggest we consider to ensure that the depositors who have actually helped build the institutions actually benefit from the transaction?

A.4. Regulators should study the methods used for allocating conversion stock among subscribing depositors to assure that long-term depositors who have contributed most to the health and success of the institution have a preference over "professional" depositors. The current system under Federal law and regulation and now in New York favors the larger depositor. This system assumes that the larger depositor is also a longer term depositor. Further study of this issue may be warranted.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM JONATHAN L. FIECHTER

Dear Mr. Chairman:

Please find enclosed for the record responses to the follow up questions you submitted to the Office of Thrift Supervision ("OTS") in conjunction with the February 25, 1994 mutual-to-stock conversion hearing held by your committee. Also enclosed are copies of our proposed and interim final rules governing mutual-to-stock conversions that were released on April 21, 1994.

Please be aware that the OTS staff recently briefed the committee staff on these rulemaking projects we undertook to amend the OTS regulations governing mutual-to-stock conversions by savings associations. The purpose of the amendments is to revise, clarify, and update the current regulations and to strengthen standards designed to ensure the integrity of the conversion process. As we

advised the committee's staff at the recent briefings, all of the issues raised by your follow-up questions, as well as the issues raised in the recent House and Senate hearings regarding perceived abuses in the conversion process, were considered by the OTS in drafting these revisions. In addition, the OTS consulted with the Federal Deposit Insurance Corporation in developing these changes to ensure consistent policy in this area.

If I may be of further assistance, please do not hesitate to contact me.

Sincerely,
Jonathan L. Fiechter, Acting Director

Q.1. In his testimony, Mr. Hove suggested a major overhaul of the conversion process, including the distribution of transferable stock purchase rights to all depositors. What is your assessment of this proposal?

A.1. Although we believe that the Federal Deposit Insurance Corporation's proposal deserves careful consideration, we do not support any changes to the OTS's current regulations at this time to permit the use of transferable subscription rights. However, amendments to those regulations request comment on this issue.

The OTS conversion regulations require that prior to the completion of a conversion, no person may transfer, or enter into any agreement or understanding to transfer, the legal or beneficial ownership of conversion subscription rights, or the underlying securities to the account of another. *See* 12 CFR §563b.3(i)(1). The FDIC and others have recently suggested that it may be appropriate for depositors to be able to transfer and sell their subscription rights so that any "windfall" value can be distributed directly to the depositors.

When the Federal Home Loan Bank Board ("FHLBB"), the predecessor agency to the Office of Thrift Supervision ("OTS"), initially proposed mutual-to-stock conversion regulations in 1973 (38 F.R. 1334, January 11, 1973), the FHLBB contemplated that depositors would be given free stock as part of the conversion and that a converting association could grant transferable subscription rights or warrants to its depositors in connection with the mutual-to-stock conversion.

After further study of the issue, however, the FHLBB concluded that the issuance of free stock and the use of transferable subscription rights was not a viable proposal and, as a result, issued a new proposal that provided for the issuance of nontransferable subscription rights to depositors to purchase the converting association's stock at its *pro forma* market value. With modifications, this proposal was adopted in 1974 (39 F.R. 9142, March 7, 1974). The fundamental premise underlying the new regulations was that no "windfall gains" should be available to anyone as part of the conversion process. The FHLBB also concluded that no method of conversion could be considered equitable unless the conversion stock was accurately appraised and sold at its *pro forma* market value. In addition, the regulations were structured to deter insider abuse by governing the manner and extent to which a savings association's insiders and their associates, individually and in the aggregate, may acquire stock and other benefits in a conversion. Finally,

the regulations sought to balance concerns such as a fair opportunity for participation by depositors and a desire to infuse significant amounts of new capital into a converting association.

The FDIC's proposal, in essence, is a variation on the free stock distribution method contemplated 20 years ago by the FHLBB. The proposal is based, in part, on assumptions that "windfall gains" are a systemic problem that cannot be eliminated through regulatory oversight.

OTS believes that its conversion regulations, including the most recent revisions, may be the most practical market-tested means available by which to address the primary issues presented by conversion transactions. They provide mutual institutions a means through which to convert to stock form and increase capital, they attempt to provide fair and equitable treatment of the depositors of the converting association and they deter insider abuse.

The use of transferable subscription rights would raise a number of novel and complex legal and policy issues. These issues include the possibility of adverse Federal tax consequences to depositors receiving such rights and to the converting savings association, undue pressure on mutual associations to convert that may evolve from significant shifts of savings funds by into such associations, difficulties in equitably allocating such subscription rights among depositors, potential manipulation of the process by sophisticated third parties to the detriment of depositors, incentives for manipulation by insiders and significantly increased conversion costs due to compliance with securities laws requirements for registering subscription rights for public distribution.

The OTS believes these issues must be carefully analyzed before considering regulatory change in this area. The agency is soliciting comment, as part of its rulemaking process, on whether subscription rights should continue to be nontransferable, or if transferability is recommended, the reasons for and the manner in which to allow for such transfer that would address the above mentioned concerns.

Q.2. Some individuals have contended that mutual form is inherently inferior to stock ownership form and that conversions should be encouraged as a matter of public policy. Should Federal policy endorse incentives that encourage conversions, particularly in the case of well-capitalized institutions?

A.2. The OTS does not believe that, as a matter of public policy, the mutual form of ownership is inherently inferior to the stock form of ownership. During the 1980's, most mutual savings associations were marginally capitalized and many were insolvent. As a result, the FHLBB undertook a number of regulatory initiatives designed, as a policy matter, to strongly encourage associations to convert to stock form. Many associations took advantage of these changes and opted to recapitalize through the conversion process. It is worth noting, however, that most of the changes enacted by the FHLBB were not designed to provide monetary benefits to insiders but were instead intended to reduce the cost and effort of the conversion process and to afford converting associations greater protection from hostile takeovers.

Currently, most mutual institutions are healthy and well capitalized. They seek to raise capital not to recapitalize but to expand their current operations through branching or through acquisition of other institutions, to engage in new activities, through both the formation of a holding company and establishment or acquisition of operating subsidiaries, and to establish stock benefit plans for management and employees. Under current industry conditions, the OTS believes that the management of a healthy mutual association should have the flexibility to make the determination as to whether and when it is in the best interest of the association to seek approval from its depositors to convert to the stock form of ownership. The OTS does not now believe that it is appropriate, as a policy matter, either to provide significant regulatory incentives to encourage healthy mutual associations to convert, or to discourage them from converting. The OTS's rulemaking project supports this view by eliminating many of the regulatory inducements adopted in the 1980's to encourage undercapitalized thrifts to convert.

Q.3. I am aware of at least one recent conversion under OTS jurisdiction in which the appraisal was performed by an affiliate of the firm handling the stock offering. How does the OTS ensure that an appraisal is truly independent?

A.3. To ensure that appraisals are independent, the OTS requires appropriate disclosure from the appraisal firm concerning its independence and subjects the appraisal to independent review by OTS staff who determine whether the appraiser has utilized appropriate methodology and whether there is sufficient data within the report to support the conclusions therein. Under the conversion regulations, every appraisal that is submitted with a conversion application must contain evidence that the firm or individual that prepared the appraisal is independent and has expertise in the preparation of corporate appraisals. *See* 12 CFR §563b.7(f). The evidence that is submitted consists of a statement by the appraisal firm that the appraisal is an "independent" appraisal and appropriate disclosure addressing whether there is any relationship between the parties other than the fee that has been paid to the firm for its services in preparing the appraisal. This information is usually provided to the OTS in the form of an affidavit or a letter that is signed by a principal of the firm.

The integrity of the conversion process rests, in large part, on the accuracy of the appraised value of the converting association and the independence of the appraiser. It is for this reason that the OTS is concerned about recent conversions that have exhibited significant increases in the immediate post-conversion trading market for the stock. Although some of the increases can be explained by the high levels of speculation that have existed generally in the market for financial institution stocks, the OTS is concerned that many appraisal reports appear to have set *pro forma* market values that were significantly below the true value of the converting associations. In such cases, the converting association is harmed because the net proceeds from the conversion, and the association's resulting capital levels, are lower when its stock is undervalued upon issuance. Conversely in this scenario, insiders and other so-

phisticated investors are able to accrue undeserved financial benefits. When the appraised value of a converting association is clearly set too low, the independence and competence of the appraiser are called into question.

The OTS relies upon the independent appraiser to submit an appraisal report that is impartial, objective, and prepared independently, without undue influence from the converting association or any of its other agents, including its attorneys, accountants, underwriters, or selling agents. In those cases where there appears to be a consistent pattern of undervaluation on the part of an appraiser, it may be difficult for the converting association to establish that the appraiser has acted independently and in a competent manner, and the OTS may reject the appraisal. In more egregious cases, the OTS may censure, suspend, or bar an appraiser from practicing before the OTS under the OTS rules of practice, 12 CFR Part 513.

As to affiliate relationships, under the current conversion regulations, the fact that a person is participating in effecting a sale of the conversion stock does not preclude such person or an affiliate from also serving as the appraiser in the conversion offering. The OTS has not experienced any problems to date where the conversion appraisal firm or its affiliate have participated in the sale of the conversion stock. The OTS believes, however, that it is essential that conversion appraisals not be tainted in any manner by a real or potential conflict in an affiliate relationship that would undermine the independence of the appraisal firm. Thus, the OTS continues to monitor this area closely. While proposing no specific rule changes, the OTS is soliciting public comments in its rulemaking proceeding as to whether appraisers should be prohibited from serving in both roles.

Q.4. S. 1801 requires converting institutions to wait 1 year before voting incentive compensation. This provision is designed to separate the decision to grant incentive compensation from the decision to convert to stock form and to ensure that such compensation is awarded by the clear owners of the institution. What is your assessment of this provision of the bill?

A.4. Past OTS policy has permitted management to receive a limited amount of stock as part of the conversion process. Given that mutual savings associations currently seeking to convert generally are well-capitalized, the OTS has become increasingly concerned that association management may be undertaking conversions for reasons other than the need for capital. Some thrift insiders may be sacrificing the interests of their associations and mutual account holders to acquire significant amounts of conversion stock and other benefits at as low a cost as possible in the conversion process. In some cases the issuance of conversion stock to management recognition plans ("MRP's") lessens the opportunity for depositors to obtain conversion stock. The issuance of stock options at the conversion price, rather than at aftermarket trading prices, which in recent years has been substantially higher than the conversion price, creates the impression that management is structuring an excessive compensation package. While the OTS believes there are valid business reasons for thrifts to adopt MRP's and stock option plans (e.g., in order to attract and retain qualified management),

these plans are now believed to be more appropriately implemented subsequent to the conversion and with shareholder approval.

The OTS is therefore substantially revising and codifying its policies regarding the establishment of MRP's and stock option plans during the conversion process. The new provisions require that any decision to implement MRP's or stock option plans after conversion be voted on and approved by a majority of the shareholders no earlier than the first annual meeting following the conversion. The rule further requires that thrift subsidiaries of mutual holding companies obtain a vote of a majority of stockholders, other than the mutual holding company, to approve such plans.[1] These provisions also prohibit the use of conversion stock to fund MRP's and require that stock options be granted only after shareholders' approval is received and at the market price at which the stock is trading at the time of grant. Any intention by management to implement MRP's or stock option plans within 1 year of conversion are 1) required to be fully disclosed in the conversion proxy, and 2) subject to the prior approval of the appropriate OTS Regional Director. The regulation codifies the OTS's current policies regarding permissible amounts that may be included in MRP's and stock option plans formed within 1 year of conversion. Codification of these policies is designed to provide clear guidance in this area.

Q.5. The OTS regulations seem to accept the traditional notion that depositors of a mutual own the institution. Yet the regulations also provide that depositors are subordinate to ESOP in the preference order for the conversion stock. Why should the ESOP or any other group receive priority?

A.5. The conversion regulations had provided an explicit top priority for tax-qualified ESOP's that permitted them to purchase up to 10 percent of the total conversion stock offering ahead of eligible depositors. This priority also was on a preferred basis; thus, in the event an offering was over-subscribed, the plans' stock purchases would not be affected. See 12 CFR §563b.3(c)23.

This provision was adopted in 1986 in connection with the adoption of other amendments to the conversion regulations to eliminate uncertainty on a variety of issues presented by ESOP's. Prior to the 1986 amendments, the first priority to purchase conversion stock had always been with eligible depositors, i.e., long-term depositors of the institution. The 1986 amendments, which granted a first priority purchase right to tax-qualified ESOP's, were based on the FHLBB's belief that acquisition of an association's stock by such plans provided a means for officials and employees of converting associations to acquire larger ownership stakes in their associations upon conversion without undermining the basic equities of the conversion process. In addition, and perhaps more significantly, the FHLBB sought to afford undercapitalized mutual savings associations, that feared hostile takeovers as public companies, a measure of anti-takeover protection through the opportunity to place a

[1] In this regard, section 10(o)(8)(B) of the HOLA requires that a mutual holding company, which is generally controlled by the management of its thrift subsidiary, must own more than 50 percent of its thrift subsidiary. Thus, absent a disinterested stockholder vote requirement, management will be able to ensure approval of its compensation plan.

significant block of conversion stock in friendly hands, and thus, encourage capital raising through conversion.

Although the OTS believes that it is still appropriate to provide management incentives and to encourage employee stock ownership in the converted association, these interests have been overshadowed by other factors. Because most mutual associations are now healthy, there is a need to balance the interests of management and employees against account holders by providing long-term depositors at mutual savings associations the first opportunity to buy conversion stock. Thus, the OTS has amended its conversion regulations to revise the stock purchase priorities to place eligible depositors before the tax-qualified ESOP's.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM WILLIAM J. DRUMM

Dear Chairman Riegle:

It was a pleasure for me to have been invited to testify before your Committee on Banking, Housing, and Urban Affairs. I hope that the information I provided and the material that follows will be helpful to you and the other committee Members. My responses to your questions are as follows:

Q.1. In his testimony, Mr. Hove suggested a major overhaul of the conversion process, including the distribution of transferable stock purchase rights to all depositors. What is your assessment of this proposal?

A.1. I agree completely with Mr. Hove's suggested overhaul of the conversion process. I do have serious reservations, however, on the distribution of transferable stock purchase rights to all depositors unless it is very carefully established and screened. Transferable stock purchase rights could be an invitation to those individuals now referred to as "flippers" to prey upon the unsuspecting and uninformed depositors, thereby enabling the "flippers" to acquire a disproportionate share of an institution. I feel that this would provide a disproportionate ownership interest for the clever speculators, a situation that was never intended when the conversion process was devised.

Q.2. Some individuals have contended that mutual form is inherently inferior to stock ownership form and that conversions should be encouraged as a matter of public policy. Should Federal policy endorse incentives that encourage conversions, particularly in the case of well-capitalized institutions?

A.2. I strongly agree that Federal policy should be designed to encourage conversions from mutual to stock. Many of the institutions that became patients of the RTC in recent years could have prevented their failure had they had a stock charter. They were caught with a mutual charter, experiencing serious drains on net worth and with no earnings or, in fact, with losses. Converting to a stock charter at that time would have been impossible. If a thrift were to convert from mutual to stock now while its net worth is good and it is making money, the opportunity to make a market of newly issued shares would be at its greatest. Incentives that would encourage conversions probably would not be necessary.

Rather, removal of any impediments to the process would be sufficient encouragement in itself.

Q.3. Conversion plans must be approved by the account holders. In many instances, however, the account holders have already provided management with "running" proxies when the accounts were opened. While account holders may revoke these proxies, critics charge that the proxy system does not ensure an adequate role for the account holders. What, if any, changes to you suggest in this area?

A.3. My best response to you in answer to this question is that Ohio's rules specifically require that new proxies be solicited when any changes to the constitution are proposed. This also would include conversion from mutual to stock. In addition to a fresh solicitation of proxies and full disclosure of the proposal, there must be a majority of three-fifths of all votes eligible to be cast. I believe that anything that is going to change the basic structure of the institution (articles of incorporation or constitution) should be made more difficult to accomplish than just the simple election of directors. Hence, my strong stance on the three-fifths majority requirement.

Q.4. In your testimony, you state that the new rules governing conversions in Ohio will "more than meet the weaknesses which are in the current regulation." Yet, under the draft that you have provided to the committee, up to 8 percent of the conversion stock may be provided to directors, officers, and employees under the MRP at no charge. This is twice the amount allowed in the current OTS regulations. How will the Ohio Banking Department protect against abuses in this area?

A.4. The draft of our rules to which you referred and of which you have a copy has since been further revised so that 8 percent of the conversion stock which could be provided to directors, officers, and employees under the MRP has been reduced to 6 percent. Our purpose in using the 6 percent is to allow this Division some latitude in the approval process. We know there are some circumstances where, because of asset size, etc., even 6 percent is too great and will be moved downward. On the other hand, there are circumstances where 6 percent may be too little but at least we will have established a reasonable cap.

Q.5. Your written testimony includes a copy of a letter to Mr. Jack Wingate concerning the conversion of Heritage Savings Bank that is dated November 18, 1994. The letter indicates that the conversion had been approved subject to certain conditions. At the same time, in response to questions concerning the Provident/Heritage deal, you stated that the transaction has not yet received "final approval." What criteria will be used to determine whether final approval is granted? You stated that your department was discussing the conversion with the FDIC. What role is the FDIC playing in deciding whether the deal receives final approval? Will the deal be submitted for FDIC approval under the interim rule adopted by the FDIC on 2/8/94?

A.5. It is difficult for me to give you an answer at this point to questions you have raised. First, I need to say that Provident had

received unconditional approval of this transaction from the Federal Reserve—I believe it was the Cleveland office that had so approved the deal. My reluctance to respond has to do with the fact that our field staff and the FDIC field staff still are continuing their examination of Heritage Savings Bank. It will be sometime next week when this office and FDIC people will sit down and discuss the Provident/Heritage deal. As soon as it is ethically proper for me to do so, I will provide you with all the information I can regarding it.

If you or other Members of the committee have any additional questions or comments, I would be pleased to respond without delay.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM DAVID E. A. CARSON

Q.1. In his testimony, Mr. Hove suggested a major overhaul of the conversion process, including the distribution of transferable stock purchase rights to all depositors. What is your assessment of this proposal?

A.1. The changes suggested stem from a seriously flawed understanding of the relationship of depositors in mutuals to those institutions. The FDIC's testimony seems to assume that depositors in mutual-form savings institutions have a legal right to benefit financially from a mutual-to-stock conversion above and beyond what they may realize by investing in conversion stock, and that the Federal Home Loan Bank Board, Office of Thrift Supervision and State regulators have improperly deprived them of this right. This assumption is wrong.

The OTS's rules and its assessment of what is due depositors uniformly have been upheld by reviewing courts. The FDIC negotiable subscription rights concept would create new rights, evidently reflecting a belief that the Corporation is better positioned to make correct judgments on corporate governance than the States that chartered the corporations. SCBA sees no justification for the FDIC's proposal to rearrange State law in this way—certainly, it has no connection with safety or soundness. Indeed, by diverting capital from institutions to depositors (whatever is raised through selling subscription rights will come out of what could be raised in the sale of stock), and setting up a dynamic that would generate tremendous pressure on mutuals to convert regardless of whether such a transaction makes sense, the FDIC proposal would seem to be very much at odds with safety and soundness.

SCBA is equally unenthusiastic about the FDIC interest in an independent financial consultant for depositors of converting institutions. Again, this proposal is grounded on a mistaken approach to depositor rights. Such consultants are not required by the FDIC to help shareholders evaluate the fairness of proposed mergers, secondary stock offering or other significant corporate decisions, and there is no reason to treat conversions differently. Their presence would be unnecessary and expensive; under the conversion approach suggested by the FDIC, they invariably would be a focus for extracting as much of the conversion proceeds as possible for depositors to the detriment of the institution's capitalization.

Q.2. Some individuals have contended that mutual form is inherently inferior to stock ownership form and that conversions should be encouraged as a matter of public policy. Should Federal policy endorse incentives that encourage conversion, particularly in the case of well-capitalized institutions?

A.2. As SCBA testified, the mutual segment of the savings institution industry is conservative, healthy and well-run, and will remain a viable and important part of the financial scene serving many local community credit needs. There certainly in nothing inherently inferior about the mutual form *vis a vis* the stock form.

In terms of whether public policy should encourage conversions, our view is that public policy should encourage strong capitalization. Mutuals that need more capital to meet regulatory benchmarks than they can retain through earnings certainly should be encouraged to convert; otherwise, public policy need not push mutuals toward conversion. A reasonable and adequate conversion incentive already exists in the ability of management, in connection within the conversion, to receive the performance-related compensation available to stock corporations generally, such as stock options.

Q.3. Conversion plans must be approved by the account holders. In many instances, however, the account holders have already provided management with "running" proxies when the accounts were opened. While account holders may revoke these proxies, critics charge that the proxy system does not ensure an adequate role for the account holders. What, if any, changes do you suggest in this area?

A.3. In our testimony, SCBA detailed the OTS rules with regard to depositor notice of and participation in a conversion vote. Depositors are given adequate notice of the vote and full disclosure of what the vote concerns. If depositors are uninterested in responding one way or the other, SCBA sees no reason why converting institutions should be unable to use running proxies and be required instead to invest the time and money needed to secure fresh proxies from indifferent mutual members.

Q.4. In most conversions, only a small minority of depositors purchase stock. Critics point out that many of these depositors are actually professional investors who maintain small accounts at numerous mutuals in hopes of cashing in on a conversion. Are there steps you would suggest we consider to ensure that the depositors who have actually helped build the institutions actually benefit from the transaction?

A.4. This suggestion is one with considerable surface appeal, but would be extraordinarily difficult to implement in practice. The question of what "bright lines" should be drawn with regard to the amount of deposits and length of relationship that would merit differing treatment, and the issues of recordkeeping would be particularly contentious and troublesome.

Some regulatory clarification of institution's ability to screen out "flippers" would be useful as a way of ensuring a greater community role in the conversion, but we would hesitate to suggest any legislated approach. It certainly is regrettable that more depositors do not participate in conversions, but one must bear in mind that

depositors tend to have a "saving" rather than an "investment" goal. Also, publicity over savings institutions' share performance in the last year or so, with declining interest rates and excellent earnings, should not obscure the fact that investment in any type of equity instrument carries significantly greater risk than that associated with maintaining a federally insured deposit account.

II

103D CONGRESS
2D SESSION

S. 1801

To apply certain minimum standards to the conversion of savings associations and savings banks from the mutual form to the stock form, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JANUARY 26 (legislative day, JANUARY 25), 1994

Mr. RIEGLE (for himself and Mr. D'AMATO) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To apply certain minimum standards to the conversion of savings associations and savings banks from the mutual form to the stock form, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Mutual Depository Institution Conversion Protection Act of 1994".

SEC. 2. MUTUAL-TO-STOCK CONVERSIONS BY STATE INSTITUTIONS.

Section 5(j) of the Home Owners' Loan Act (12 U.S.C. 1464(j)) is amended to read as follows:

"(j) STOCK CONVERSIONS BY STATE INSTITUTIONS.—

"(1) APPLICATION OF FEDERAL REGULATIONS.—A converting institution shall be subject to such regulations as the Director shall prescribe. The appropriate State regulatory authority may impose more restrictive rules or regulations on such conversions if it deems such action to be appropriate.

"(2) LIMITATION ON INSIDER TRANSACTIONS.—An officer, director, or employee of a converting institution may purchase or receive, directly or indirectly, shares of or any other beneficial interest in that institution only under the same terms and conditions and only in the same amounts as are available—

"(A) to any depositor of the institution who is not otherwise affiliated with the institution, if such officer, director, or employee is a bona fide depositor of the institution; or

"(B) generally to any other person who is not affiliated with the institution, if such officer, director, or employee is not a bona fide depositor of the institution.

"(3) CONSIDERATION OF ADDITIONAL COMPENSATION.—No proposal may be made to the

shareholders of a converted institution during the 1-year period beginning on the date of conversion to increase the direct or indirect compensation of an officer, director, or employee of the institution in excess of the compensation of such person prior to the date of the conversion.

"(4) AGGREGATE LIMIT ON BENEFICIAL INTERESTS OF INSIDERS.—The Director shall, by regulation, establish an appropriate aggregate percentage of and an aggregate dollar limitation on the beneficial interests in a converting institution that may be held, directly or indirectly, by any officer, director, or employee of the institution.

"(5) DEFINITIONS.—For purposes of this subsection—

"(A) the terms 'State savings association' and 'State savings bank' have the same meanings as in section 3 of the Federal Deposit Insurance Act;

"(B) the term 'converted institution' means a State savings association or State savings bank that converted from the mutual form to the stock form after January 26, 1994; and

"(C) the term 'converting institution' means a State savings association or a State

savings bank that is converted from the mutual form to the stock form after January 26, 1994.".

SEC. 3. CONVERSIONS BY FEDERAL INSTITUTIONS.

Section 5(i) of the Home Owners' Loan Act (12 U.S.C. 1864(i)) is amended by adding at the end the following new paragraph:

"(5) INSIDER TRANSACTIONS AND COMPENSATION.—

"(A) IN GENERAL.—In any conversion, on or after January 26, 1994, of a Federal savings association or a Federal savings bank from the mutual form to the stock form—

"(i) an officer, director, or employee of the institution that is the subject of the conversion may purchase or receive, directly or indirectly, shares of or any other beneficial interest in that institution only under the same terms and conditions and only in the same amounts as are available—

"(I) to any depositor of the institution who is not otherwise affiliated with the institution, if such officer, di-

rector, or employee is a bona fide depositor of the institution; or

"(II) generally to any other person who is not affiliated with the institution, if such officer, director, or employee is not a bona fide depositor of the institution; and

"(ii) no proposal may be made to the shareholders of the institution during the 1-year period beginning on the date of conversion to increase the direct or indirect compensation of an officer, director, or employee of the institution in excess of the compensation of such person prior to the date of the conversion.

"(B) AGGREGATE LIMIT ON BENEFICIAL INTERESTS OF INSIDERS.—The Director shall, by regulation, establish an appropriate aggregate percentage of and an aggregate dollar limitation on the beneficial interests in any institution that is the subject of a conversion described in subparagraph (A) that may be held, directly or indirectly, by any officer, director, or employee of the institution.".

SEC. 4. REGULATIONS.

Not later than 90 days after the date of enactment of this Act, the Director of the Office of Thrift Supervision shall promulgate final regulations to implement subsections (i)(5) and (j) of section 5 of the Home Owners' Loan Act, as amended by this Act.

SEC. 5. STUDY AND REPORT.

(a) STUDY.—The Secretary of the Treasury shall conduct a study to determine—

(1) the adequacy of existing Federal law in ensuring equity and fairness in the conversion of savings associations and savings banks from the mutual form to the stock form;

(2) the accuracy of existing stock appraisal and valuation techniques employed in such conversions; and

(3) the adequacy of disclosures to depositors and the public concerning such conversions.

(b) REPORT.—Not later than 1 year after the date of enactment of this Act, the Secretary of the Treasury shall submit to the Congress a report of the results of the study conducted under subsection (a).

○

HOBART AND WILLIAM SMITH COLLEGES

February 23, 1994

Senator Donald W. Riegle
Chairman, Senate Committee on Banking,
Housing, and Urban Affairs
534 Dirksen Building
Washington, DC 20510

Phone 202 224-3225
FAX 202 224-5137

Re: Testimony on Mutual Savings Bank to Stock Bank Conversions

Dear Mr. Senator Riegle:

There is a very simple solution to the current problem of egregious insider abuse and, more importantly, the expropriation of the depositors's net worth when thrift institutions convert from mutual ownership to stock ownership. That solution is to allow complete conversion to stock ownership with the shares to be given to the depositors pro rata. The advantages to this proposal are:

- each mutual depositor would keep his or her right to vote, not as a depositor, but as a stockholder.
- each mutual depositor would keep his or her share of the bank's net liquidated wealth.
- there would be no question as to the "underpricing of the stock" in the initial offering and hence no question of insider trading.
- there would be no stock to give to the managers and to boards of trustees, so there would be none of the outrageous stock gifts that we have seen and are pending.
- there would be no reason for the price of the newly issued stock to increase by (an average of) 30 percent the first day and as much as 50 percent the first month. There would be no stock on which to give stock options to current managers and trustees, so none of these outrageous insider gifts would be available. But even if stock options were offered on additional diluted stock offerings, they would be voted on by the shareholders and not used to "steal" the current depositors' net worth.
- the simplicity of such a conversion would reduce the transactions cost associated with the current conversions involving complicated holding companies, incentive plans, and other shell games which are designed to enrich the current managers and perpetuate their control of the bank's assets.

Allow me it illustrate this proposal with an example of our local savings bank which has assets of only $167 million.

315: 789-5500
Geneva, New York 14456-3397

As a mutual savings bank the balance sheet now looks like this:

$'000,000				
Assets		Liabilities		
cash	$ 2	deposits	$ 150	
loans	$ 81	net worth	$ 17	the depositors actually own this net worth
other	$ 84			
total	$ 167	total	$ 167	

With the sale of 1,700,000 shares of stock at $10 per share and a reorganization to a stock company, the balance sheet would look like this

$'000,000				
Assets		Liabilities		
cash	$ 19	deposits	$ 150	
loans	$ 81	net worth	$ 34	the shareholders would own all of this net worth which amounts to $20 per share.
other	$ 84			
total	$ 184	total	$ 184	

This is the key to why stock in these conversions is expected to double in price and how insiders profit from it. It is not just speculation on an initial public offering; it is a guarantee for new stockholders to own not only what they just paid for the stock but a share of the former depositors' net worth as well.

Under my proposal of complete conversion to a stock company the balance sheet would not change, except that the $17 million in net worth would belong to the same depositors, not just to depositors who could afford to buy shares, managers, trustees, and insider traders. The depositors' $17 million in net worth would be worth $10 per share based upon 1.7 million shares distributed pro rata to them. More importantly, they would not lose as they would in a typical conversion.

Who would be against such a simple plan which is so equitable? The following people would stand to lose and would raise the most vocal objections:

- bank managers They would be precluded from awarding themselves lucrative gifts of stock, stock options, and enhanced employment contracts which are now a part of typical reorganization plans.

- boards of trustees They would not be able to profit from stock options and other gifts which they now expect to receive in a typical current conversion. It is my opinion that most boards of trustees, particularly those of small, mutual savings banks, endorse current conversions not out of greed but out of ignorance; board members are persuaded by management with arguments of "the need to grow" and by a plan so complicated that none of them bothers to read and understand it.

- large legal firms Firms like Elias, Matz, Tiernan & Herrick will lose large fees for drafting, boilerplating, and promoting current reorganization plans.

- <u>some bank regulators</u> As the regulation of all depository institutions becomes more centralized, criticism is likely to mount regarding those regulators who have already allowed the expropriation of depositors' net worth and have remained silent during the past years' conversions which they knew only served to line the pockets of bank managers and insiders.

I am in the process of opposing the reorganization plan of the Savings Bank of the Finger Lakes here in Geneva, New York. The proposed disenfranchisement of our depositors and the enrichment of our bank managers and trustees pales in comparison with Green Point and other recent cases. But all the elements are there, albeit on a smaller scale.

The Office of Thrift Supervision has deemed my written protest "substantial," but I am not a lawyer, nor do I have the resources to fight the reorganization plan in the courts. I believe that legislation is necessary to stop this abuse and legal theft of mutual thrift depositors' net worth. I am willing to consult with your office and to testify in any hearings which the banking committees may convene.

Sincerely,

Daniel A. McGowan

Daniel A. McGowan
Professor of Economics

Phone 315 781-3418
FAX 315 781-3422

If this testimony needs to be notarized or written in any other form, please notify me immediately. If the committee would like me to present it in person, allowing for clarification and expansion of points raised, please advise.

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I commend you for convening this hearing on S. 1801, the "Mutual Depository Institution Conversion Act of 1994." I also want to welcome Mr. Derrick Cephas, the New York Banking Superintendent, who has played a leading role in stopping some of the abuses associated with mutual-to-stock conversions.

Recent events, including some in my home State of New York, demonstrate that we need to tighten up the regulation of mutual-to-stock conversions. This issue is important to all individuals who have deposits in mutual savings associations, and to ensure continued public confidence in our financial regulatory system.

In our financial system, there are two types of savings institutions. Stock savings banks are incorporated institutions owned by their shareholders, and managed by an elected board of directors. Mutual savings banks have no shareholders, are owned by the depositors, and managed by a board of trustees.

It is not uncommon for a mutual savings bank to convert to stock form, and there are excellent reasons for such conversions. For example, a conversion may be used to raise capital for an institution.

However, the conversion process can be and has been misused. Through generous stock option and other compensation plans, predatory acquirors entice management to proceed with conversion plans that confer windfall benefits on the acquirors. Insiders at mutual savings bank—the very trustees who have a fiduciary duties to the depositors—may seek to convert the institution to stock form in order to profit financially from stock options and other preferential stock distributions. In these cases, the depositors, the actual owners of the institution, benefit minimally, if at all, from the conversion, while the insiders and acquirors get rich.

Recently, in my State of New York, the trustees of the Green Point Savings Bank wanted to convert the institution to a stock savings bank. In the process, the insiders would have received stock worth many tens of millions.

Fortunately, the New York State Banking Department Superintendent Derrick Cephas, stepped in to prevent this deal from going forward under the original terms. Mr. Cephas issued an order requiring Green Point to cancel all stock grants to insiders, eliminate other personal benefits for the trustees, and appoint three new independent outside directors who will report directly to the Banking Department.

However, these general problems raised by conversions are far from solved. While Mr. Cephas has taken forceful and decisive action in New York, conversions of this nature are going on across the Nation.

Chairman Riegle and I have joined in introducing legislation to set basic depositor protection standards for mutual-to-stock conversions. These new Federal standards will set a floor, not a ceiling. State regulators will be free to provide additional protection. But if the States do not act, or do not provide sufficient protection on their own, our legislation will establish fundamental depositor rights needed to protect our citizens from this type of financial abuse.

I would like to hear from the witnesses on whether they believe that our bill takes the appropriate path, and if there are any ways to improve it.

Thank you, Mr. Chairman.

Office of Thrift Supervision
Department of the Treasury
Director

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

May 5, 1994

The Honorable Alfonse M. D'Amato
Committee on Banking
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator D'Amato:

As a follow up to the February 25, 1994 mutual to stock conversion hearing held by the Committee on Banking, Housing and Urban Affairs, you requested that the Office of Thrift Supervision ("OTS") provide you with a list of conversion applications approved by OTS after January 26, 1994, the grandfather date contained in S. 1801. In addition, you requested OTS's views on provisions of S. 1801 that would prohibit savings associations and state savings banks from proposing management compensation packages for stockholder approval for at least one year following conversion to stock form.

As to your first inquiry, attached is a list of conversion transactions approved by OTS between January 26, 1994 and May 3, 1994.

As to your second inquiry, OTS recently responded to follow-up questions from Chairman Riegle regarding certain issues raised at the February 25 hearings. OTS's response addressed, among other things, this agency's views regarding the management compensation provisions of S. 1801. A copy of that response is attached.

Please be aware that on April 21, 1994 the OTS announced adoption of an interim final rule that revises, updates and clarifies the current OTS conversion regulations to strengthen standards designed to ensure the integrity of the conversion process. This regulation became effective upon publication in the Federal Register on May 3, 1994.

In addition, the OTS has issued a proposed rule that, if adopted, will require the OTS, in connection with its review of conversion applications, to consider the extent to which the transaction will affect the convenience and needs of the communities to be served by the applicant. Copies of these rules are attached.

The OTS staff recently briefed the Banking Committee's staff on these rulemaking projects. As we advised the Committee's staff at these briefings, all of the issues raised in the recent Senate and House hearings regarding perceived abuses in the conversion

process, as well as the issues raised by Chairman Riegle's follow-up questions, were considered by OTS in drafting these revisions. In addition, the OTS has consulted with the Federal Deposit Insurance Corporation in developing these changes to ensure consistent policy in this area.

If I may be of further assistance, please do not hesitate to contact me.

Sincerely,

Jonathan L. Fiechter
Acting Director

Attachments

APPLICATIONS FOR CONVERSIONS
APPROVED AFTER JANUARY 26, 1994
BY THE OFFICE OF THRIFT SUPERVISION

First Missouri FS&LA
Brookfield, Missouri

Marshalltown Savings Bank, FSB
Marshalltown, Iowa

Permanent Federal Savings Bank
Evansville, Indiana

Perpetual Savings Bank, FSB
Cedar Rapids, Iowa

Princeton FS&LA
Princeton, Kentucky

Redlands Federal Bank, FSB
Redlands, California

Mid-Central Federal Savings Bank
Wadena, Minnesota

Southern Missouri Savings Bank
Poplar Bluff, Missouri

Long Island Savings Bank
Syosset, New York

First FS&LA of Barrington
Barrington, Illinois

Wichita FS&LA
Wichita, Kansas

Harbor FS&LA
Baltimore, Maryland

Mid-Continent FS&LA of El Dorado
El Dorado, Kansas

First Federal Bank of Eau Claire, FSB
Eau Claire, Wisconsin

Mutual Savings Bank
Jefferson City, Missouri
(Mutual Holding Company)

First Savings Bank of New Jersey
Bayonne, New Jersey
(Mutual Holding Company)

markets, the Secretary used his discretion to limit the increase to 65 percent of the maximum allowable increase. Accordingly, the 1994 crop of burley tobacco will be supported at 171.4 cents per pound, 3.1 cents higher than in 1993.

List of Subjects

7 CFR Part 723

Acreage allotments, Marketing quotas, Penalties, Reporting and recordkeeping requirements, Tobacco.

7 CFR Part 1464

Loan programs—agriculture, Price support programs, Reporting and recordkeeping requirements, Tobacco, Warehouses.

Accordingly, 7 CFR parts 723 and 1464 are amended as follows:

PART 723—TOBACCO

1. The authority citation for 7 CFR part 723 continues to read as follows:

Authority: 7 U.S.C. 1301, 1311–1314, 1314–1, 1314c, 1314d, 1314f, 1314h, 1315, 1316, 1363, 1372–75, 1377–1379, 1421, 1445–1, and 1445–2.

2. Section 723.112 is amended by:

A. Redesignating existing text as paragraph (a), and

B. Adding paragraph (b) to read as follows:

§ 723.112 Burley (type 31) tobacco.

* * * * *

(b) The 1994-crop national marketing quota is 542.7 million pounds.

PART 1464—TOBACCO

3. The authority citation for 7 CFR part 1464 continues to read as follows:

Authority: 7 U.S.C. 1421, 1423, 1441, 1445, 1445–1 and 1445–2; 15 U.S.C. 714b and 714c.

4. Section 1464.19 is amended by:

A. Redesignating existing text as paragraph (a), and

B. Adding paragraph (b) to read as follows:

§ 1464.19 Burley (type 31) tobacco.

* * * * *

(b) The 1994-crop national price support level is 171.4 cents per pound.

Signed at Washington, DC, on April 22, 1994.

Bruce R. Weber,

Acting Administrator, Agricultural Stabilization and Conservation Service and Executive Vice President, Commodity Credit Corporation.

[FR Doc. 94–10482 Filed 5–2–94; 8:45 am]

BILLING CODE 3410–05–P

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Parts 563b and 575

[No. 94–48]

RIN 1550–AA73

Conversions From Mutual to Stock Form

AGENCY: Office of Thrift Supervision, Treasury.

ACTION: Interim final rule with request for comments.

SUMMARY: The Office of Thrift Supervision (OTS) is amending its regulations governing mutual-to-stock conversions of insured savings associations. The purpose of these amendments is to revise, clarify and update the current regulations to strengthen the conversion standards and ensure the integrity of the conversion process.

The amendments revise and clarify the appraisal standards; prohibit the use of "running" proxies by management of converting associations; place the current tax-qualified Employee Stock Ownership Plan (ESOP) stock purchase priority after those of eligible depositors; provide stock purchase priority to long-term depositors; require that a stock purchase preference be given to eligible depositors residing in the association's local community; prohibit management stock benefit plans in a conversion; prohibit merger conversions except in supervisory situations; lengthen the conversion public comment period; require associations to submit business plans for all conversions; prohibit the repurchase of a converted association's stock within one year of conversion; and make publicly available preliminary conversion proxy materials.

Interested parties are invited to submit written comments on the conversion regulations, both as to the amendments adopted here and the issues on which comment is specifically solicited and as to any other current provisions of the conversion regulations as they relate to this interim rule.

DATES: The interim final rule is effective May 3, 1994. Written comments must be received on or before June 17, 1994. These amendments will apply to all conversion applications pending or filed on or after May 3, 1994.

ADDRESSES: Comments should be directed to Director, Information Services Division, Public Affairs, Office of Thrift Supervision, 1700 G Street NW., Washington, DC 20552, Attention: Docket No. 94–48. These submissions may be hand delivered to 1700 G Street, NW., from 9 a.m. to 5 p.m. on business days; they may be sent by facsimile transmission to FAX number (202) 906–7755. Comments will be available for inspection at 1700 G Street NW., from 1 p.m. until 4 p.m. on business days. Visitors will be escorted to and from the Public Reference Room at established intervals.

FOR FURTHER INFORMATION CONTACT: Teri M. Valocchi, Counsel (Banking and Finance) (202/906–7299), James H. Underwood, Special Counsel (202/906–7354), Leon R. Pleasants, Chief Financial Analyst (202/906–6414), J. Larry Fleck, Assistant Chief Counsel (202/906–6413), V. Gerard Comizio, Deputy Chief Counsel (202/906–6411), Corporate and Securities Division, Chief Counsel's Office; Scott Ciardi, Financial Analyst (202/906–6960); David A. Siogren, Program Manager (202/906–6739), Diana L. Gammus, Deputy Assistant Director (202/906–5683), Corporate Activities Division, Office of Thrift Supervision, 1700 G Street NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Introduction

The OTS has broad authority to authorize and regulate mutual to stock conversions of savings associations under sections 5(i) and (p) of the Home Owners' Loan Act, as amended (HOLA), 12 U.S.C. 1464(i) and (p).[1] For the past 20 years—since the OTS's predecessor, the Federal Home Loan Bank Board (FHLBB) instituted mutual to stock conversion regulations in 1974[2]—mutual to stock conversions have been a successful vehicle for bringing new capital into the thrift industry. Since 1974, over 1,000 mutual savings associations have converted to the stock form of ownership, in the process raising approximately $16 billion in new capital.

While mutual to stock conversions provide an opportunity for thrifts to raise capital, they may also provide an opportunity for an association's insiders to engage in transactions that transfer to the insiders an inappropriate amount of a converting association's value. Thus, the OTS mutual to stock conversion regulations reflect standards and safeguards developed over the years to maintain the integrity of the conversion process, to ensure safety and soundness by responding to the potential for

[1] The OTS also has broad authority to approve and regulate mutual savings and loan holding companies under section 10(o) of HOLA, 12 U.S.C. 1467a(o).

[2] 39 FR 9142 (March 7, 1974).

abuses in thrift conversions and to allow the conversion process to function effectively as a capital raising tool.

The OTS mutual to stock conversion regulations seek to balance concerns such as a fair opportunity for participation by account holders and the desire to infuse significant amounts of new capital into converting savings associations. In addition, the regulations are structured to assure that a savings association receives fair value for its conversion stock and to prevent insider abuse by governing the manner and extent to which a savings association's insiders and their associates, individually and in the aggregate, may acquire stock and other benefits in a conversion.

In recent months, mutual to stock conversions have become the subject of controversy and negative media attention. In particular, there has been controversy over the fact that some states offer insiders of state savings banks the opportunity to gain potentially greater benefits and more generous compensation packages than are currently permitted under OTS rules. Congress also has expressed serious concerns in this area. Legislation has been introduced in both the House and Senate to address the issue of minimum standards for conversions by state savings banks and limitations on management benefits in conversions. In addition, both the Financial Institutions Subcommittee of the House Banking Committee and the Senate Banking Committee recently have held hearings on perceived abuses in mutual to stock conversions.

Although the OTS believes that its current regulations have generally provided sound safeguards for mutual to stock conversions, the OTS and the FHLBB, in administering the conversion program, have refined the conversion regulations periodically in light of experience with the conversion process and in response to developments in the market place. As a result of the recent events concerning mutual to stock conversions, the OTS has again reviewed its conversion regulations to assess whether additional revisions to its rules are necessary.

As part of its review, the OTS has analyzed the changing financial condition of converting mutual associations. During the 1980s, most mutual savings associations were marginally capitalized and many were insolvent. As a result, the FHLBB undertook a number of regulatory initiatives designed to encourage associations to convert to stock form. Many associations took advantage of these changes to recapitalize. Now, however, most mutual institutions in the industry are healthy. Generally, these healthy institutions are not converting to meet regulatory capital requirements. Instead, they seek to raise capital to expand their current operations through branching or acquiring other institutions, to engage in new activities, through both the formation of a holding company and establishment or acquisition of operating subsidiaries, and to establish stock benefit plans for management and employees. This change in the reasons for conversions has caused the OTS to rethink the need for the regulatory inducements for conversion contained in the current regulations.

Based upon the foregoing, the OTS has identified several areas of the regulations, discussed below, that it has determined to revise, update and clarify to further strengthen the standards governing the conversion process. The OTS has consulted with the Federal Deposit Insurance Corporation ("FDIC") in developing these changes to ensure consistent policy in this area. The OTS also has determined to adopt the amendments immediately as an interim final rule to protect the integrity of the conversion process. As such, the final rule is designed to assure the public that the conversion program will continue to be fair and equitable. Also, Congress has made it clear that it expects both the OTS and the FDIC to act promptly to assure that any abuses or potential abuses in the mutual to stock conversion area are addressed.

II. Description of Revisions to Conversion Regulations

A. Revision to the Appraisal Standards

Pursuant to 12 CFR 563b.3(c)(1), a converting savings association is required to sell its capital stock at a total price equal to its estimated *pro forma* market value, based on an independent valuation. When the FHLBB adopted the initial conversion regulations, it found that underpricing conversion stock would result in "windfall" distributions of the value of a converting association and that no method of conversion could be considered equitable unless the conversion stock was accurately appraised and sold at its *pro forma* market value. This was necessary to assure that the association received full value for the conversion stock it distributed.

The current regulations contain safeguards designed to enhance the accuracy of conversion appraisals. Under 12 CFR 563b.7(f), the OTS requires that the appraisal be prepared by an appraiser who is independent of the converting association and who has expertise in the area of corporate appraisals. Although the conversion regulations have been amended numerous times since 1974, the requirement that the conversion stock be sold at its *pro forma* market value has remained constant.

The integrity of the conversion process rests, in large part, on the accuracy of the appraised value of the converting association. It is for this reason that the OTS is concerned about recent conversions that have exhibited significant increases in the immediate post-conversion trading market for the stock. Although some of these increases can be explained by the high levels of speculation that have existed generally in the market for financial institution stocks, the OTS is concerned that many of these appraisal reports may have set *pro forma* market values that were significantly below the true value of the converting associations. In such cases, the converting association is harmed because the net proceeds from the conversion, and the association's capital levels, are lower as a result of its stock being undervalued upon issuance. Conversely, insiders and other sophisticated investors are able to accrue undeserved financial benefits. When this occurs, the independence and competence of the appraiser are called into question.

The OTS relies on the independent appraiser to submit an appraisal report that is impartial, objective and arrived at independently, without undue influence from the converting association or any of its other agents, including its attorneys, accountants, underwriters or selling agents. The OTS is taking this opportunity to remind those persons serving as conversion appraisers that the current regulations require that the conversion applicant submit information demonstrating, to the satisfaction of the OTS, the independence and expertise of the appraiser.[1] In those cases where there appears to be a consistent pattern of undervaluation on the part of an appraiser, it may be difficult for the applicant or the appraiser to establish that the appraiser has acted independently and in a competent manner. In more egregious cases, the OTS also may determine to censure, suspend or bar an appraiser from practicing before the OTS under the OTS rules of practice, 12 CFR part 513.

Under the current rules, § 563b.7(f)(1)(ii) permits the appraisal report to contain a "brief summary" of data that is sufficient to support the

[1] 12 CFR 563b.7(f)(2)

appraiser's conclusions as to the pro *forma* market value of the converting association. Section 563b.7(f)(3), however, permits the OTS to request additional information with respect to the pricing of the converting association's capital stock. In practice, the OTS, relying on § 563b.7(f)(3), has required that a full appraisal report be submitted as part of the conversion application. In that regard, the OTS and its predecessor, the FHLBB, have provided detailed policy guidance to the industry regarding appropriate appraisal standards to be used in valuing conversion stock.[4]

In order to eliminate any potential confusion in this area, the OTS is amending § 563b.7(f)(1)(ii) by deleting suggestions that the appraisal report need only be a "brief summary" and specifying that a full appraisal report is required. The revised language codifies the current practice of OTS staff requiring a more complete and detailed description of the elements that make up an appraisal report and justification for the methodology employed. Because a full appraisal will now be required under paragraph (f)(1)(ii), the reference to "full appraisal" in § 563b.7(f)(3) is unnecessary and is deleted. The OTS expects that appraisals will continue to contain sufficient detail to support the conclusions contained therein and that appraisers will deliberate carefully in the formation of an opinion to arrive at a *pro forma* market value that is consistent with post-conversion market values.

Section 563.7(f) also has been revised to provide that in those instances where the initial appraisal report is deemed to be materially deficient and/or substantially incomplete, the OTS may deem the entire conversion application materially deficient and/or substantially incomplete, and in accordance with the OTS applications processing rules, 12 CFR part 516, decline to further process the application. In such cases, the applicant will be required to refile the conversion application, including a revised appraisal, as a new application and pay any applicable filing fees.

Under current § 563b.7(f)(2), the fact that a person is participating in effecting a sale of the conversion stock, either as an underwriter or as a selling agent, does not preclude such person or an affiliate of such person from being considered independent for purposes of preparing the appraisal for the conversion. Although the staff has not experienced any problems to date where a conversion appraisal firm or its affiliate have participated in effecting the sale of the conversion stock, the OTS believes that it is essential that conversion appraisals not be tainted in any manner by a real or potential conflict in such an affiliate relationship that would cause the appraiser to not be independent in his or her judgments. Thus, while no changes are being adopted at this time, the OTS is requesting public comment as to whether it should amend § 563b.7(f)(2) to prohibit an appraiser or its affiliates from also serving as an underwriter or selling agent.

Finally, in order to further enhance regulatory oversight in this area, the OTS intends to issue updated guidance for conversion appraisers that will provide specific details on appraisal methodology and report content.

B. Prohibition on Use of "Running" Proxies

Section 563b.5(d)(4), adopted in 1985, provides for management of a converting association to use previously obtained proxies, *i.e.*, "running" proxies, from a voting member. Previously, the conversion rules prohibited the use of "running" proxies. The requirement was changed in 1985 to reduce conversion costs for marginally capitalized savings associations.[5]

Section 563b.5(d)(4), however, requires that each voting member be furnished a proxy statement on the special plan of conversion meeting, and only allows for use of the "running" proxy in the event the voting member does not grant a later-dated proxy to vote at the meeting called to consider the plan of conversion or attend such meeting and vote in person.

Currently, as discussed in section I. above, most mutual associations in the thrift industry seeking to convert are well-capitalized. Thus, the regulatory rationale for truncating the proxy solicitation and voting requirements generally no longer exists. In addition, depositors in greater numbers recently have expressed increased interest in the conversion plans of their associations. The OTS believes, based on its experiences in this area, that the current ability to use "running" proxies has lessened the incentive of converting associations to actively solicit depositors to consider and vote on conversions.

Thus, the OTS has decided to revise § 563b.5(d)(4) to prohibit the use of "running" proxies. The OTS believes the prohibition is the most effective manner in which to assure full participation of the association's membership in the conversion process. The requirement to use a proxy specifically designed for the conversion will require thrift management to more actively solicit its depositors to obtain their votes for conversion.

In addition, the last two paragraphs of Item 1 and Item 4(d) of the Form PS have been revised to conform with the revisions discussed above. Finally, a sentence has been added to § 575.13(a)(4) of the mutual holding company regulations to conform with this revision.

C. Re-Prioritize Stock Purchase by Tax-Qualified Employee Stock Ownership Plans.

Under OTS rules, a conversion offering may involve as many as three phases: A subscription offering, a direct community offering and an underwritten public offering. Only the subscription offering phase, which affords account holders the opportunity to subscribe for stock on a priority basis, is required; if all of the stock is purchased in the subscription phase, any other offering is unnecessary.

The conversion regulations protect the status of mutual account holders by establishing a detailed series of subscription priorities for purchases of conversion stock. Currently, § 563b.3(c)(2) requires that first priority to purchase the stock issued in the conversion, after certain tax-qualified ESOP purchases, discussed below, belongs to eligible account holders, *i.e.*, depositors holding qualifying deposits at the savings association as of a date (eligibility record date) at least ninety days prior to the date of adoption of the plan of conversion by the association's board of directors.[6] The regulations also provide that each eligible account holder must receive, without payment, nontransferable subscription rights in an amount equal to the greater of the maximum purchase limitation established under the converting association's plan of conversion, or certain formulas prescribed under the regulations.[7]

In 1986, amendments to the conversion regulations were adopted to eliminate uncertainty on a variety of issues presented by employee stock benefit plans and to enhance the ability of officers, directors and employees of a

[4] FHLBB, Guidelines for Appraisal Reports for the Valuation of Savings and Loan Associations and Savings Banks Converting From Mutual to Stock Form of Organization (October 1983); FHLBB, Guidelines for the Valuation of Savings and Loans Converting from Mutual to Stock Form (June 15 1981).

[5] 50 FR 20558 (May 17, 1985).

[6] 12 CFR 563b.2(aa)(16).

[7] 12 CFR 563b.3(c)(2).

savings association to acquire stock when the association converted, through various types of employee stock benefit vehicles.[8] Prior to the 1986 amendments, the first priority to purchase conversion stock had always been with eligible account holders. The 1986 amendments, which granted a first priority purchase right to tax-qualified employee benefit plans, were based on the FHLBB's belief that acquisition of an association's stock by such plans provided a means for officers and employees of converting associations to acquire larger ownership stakes in their associations upon conversion without undermining the basic equities of the conversion process.[9] In addition, and perhaps more significantly, the FHLBB sought to afford undercapitalized mutual savings associations, that feared hostile takeovers as a public company, a measure of anti-takeover protection through the opportunity to place a significant block of conversion stock in friendly hands, and thus, encourage capital raising through conversion.

Section 563b.3(c)(23) currently provides an explicit top priority for tax-qualified employee stock benefit plans that permits plans to purchase up to 10% of the total conversion stock offering ahead of eligible depositors. This priority also is on a preferred basis; thus, in the event an offering is over-subscribed, the plans' stock purchases will not be affected.

Although the OTS believes that it is still appropriate to provide management incentives and to encourage employee stock ownership in the converted association, these interests have been overshadowed by other factors. Because most mutual associations are now healthy, there is a need to balance the interests of management and employees against those of account holders by providing long-term depositors at mutual savings associations the first opportunity to buy conversion stock. The OTS is therefore amending § 563b.3(c)(23) to revise the stock purchase priorities so as to place eligible account holders before the tax-qualified employee stock benefit plans and to place tax-qualified employee stock benefit plans before supplemental eligible account holders [10] and all other voting members who have subscription rights. Finally, the OTS is amending § 563b.3 (c)(6)(i), (c)(7), and (d)(4) to conform to these changes.

D. Revision to Eligibility Record Date

As discussed above, the intent of the eligibility record date is to give long-term depositors a priority in purchasing stock. It has been the OTS's experience, however, that converting associations have opted for the minimum 90-day period for determining who is a long-term depositor. Upon review of this area, the OTS does not believe that use of the minimum 90-day period is a meaningful indicator of long-term depositor status and should be substantially lengthened. Thus, the OTS is amending the existing rule to require that the eligibility record date be set at a date no less than a year prior to board of director approval of the plan of conversion. In so doing, the OTS stresses that the one year period is a minimum time period; converting associations are encouraged to establish longer time periods to maximize the stock purchase priority for long-term depositors. The OTS also is requesting public comment as to whether a longer minimum time period would be appropriate.

E. Priority to Account Holders and Voting Members Residing in the Association's Local Community

The current conversion regulations require that, following the subscription offering of conversion stock to account holders, all nonsubscribed shares be sold either in a public offering or a direct community offering giving "a preference to natural persons residing in the counties in which the association has an office."[11] Thus, the regulations currently permit a converting association to conduct a community offering of conversion stock in the local community, prior to a general public offering. The current regulations, however, do not permit converting associations to give account holders and voting members in those local communities a priority to purchase stock in the initial subscription offering. The OTS, has, however, on a case by case basis, recently permitted thrift subsidiaries of mutual holding companies to prioritize stock purchases in this manner.

Upon consideration of its favorable experiences with local community stock priorities in stock offerings of thrift subsidiaries of mutual holding companies, the OTS now believes it is appropriate to require converting associations to give the local community a more meaningful opportunity to participate in all conversions on a priority basis at the subscription offering stage. Accordingly, new § 563b.3 (c)(2)(i), (4)(i), and (5)(i) have been added to extend this preference to the eligible account holder, supplemental eligible account holder and other voting member priorities in the subscription stock offering. The preference in each priority group will be to those persons who reside in the association's "local community" or within 100 miles of a home or branch office of the converting association. The term "local community" is defined in new § 563b.2(a)(19) to include all counties in which the converting association has a home or branch office, each county's standard metropolitan statistical area or the general metropolitan area of each of these counties and such other similar local area(s) as provided for in the converting association's plan of conversion, as approved by the OTS. Current § 563b.3(c)(2)(ii)–(iii), 4(i)–(iv) and (5)(i)–(ii) will be redesignated as § 563b.3(c)(2)(ii)–(iii), (4)(ii)–(v) and (5)(ii)–(iii). For purposes of consistency, section 563b.3(c)(6)(iv) is revised to conform with new section 563b.3(c)(2)(i).

Additionally, 12 U.S.C. 1464(b) and 12 CFR 545.11(b) establish that a federally chartered savings association may accept and maintain deposit accounts within its discretion and subject to criteria established by the association. The OTS solicits public comment on whether a converting association should have the ability to prevent depositors who do not reside in the local community from participating in a conversion. In addition, the OTS specifically solicits comments as to whether an association, in anticipation of conversion, should be permitted to: (1) refuse to open accounts for potential depositors residing outside the local community, and (2) close accounts of depositors residing outside the local community.

F. Revision of Policy Regarding Management Stock Benefit Plans

Under § 563b.3(c)(8), the amount of stock that officers, directors and their associates can purchase, in the aggregate, is limited to between 25% to 35% of the conversion stock, based upon the total asset size of the converting association. In addition, existing § 563b.3(c)(6)(i) allows any one or more tax-qualified employee stock benefit plans to purchase in the aggregate not more than 10% of the total offering of shares and allows such purchase regardless of the number of shares to be purchased by other parties

[8] 51 FR 40127 (November 5, 1986).

[9] *Id.*

[10] The term "supplemental eligible account holder" means any person holding a qualifying deposit, except officers, directors and their associates, as of the last day of the calendar quarter preceding the OTS's approval of the application for conversion. See current 12 CFR 563b.2 (a)(37) and (a)(38).

[11] 12 CFR 563b.3(c)(6).

Current OTS policy also permits management stock benefit and recognition plans (collectively "MRPs") to purchase up to 3% or 4% of the conversion stock, depending upon the association's capital position.[12] Current OTS policy limits the combined ESOP and MRP purchases to 10% to 12% of the conversion stock, depending upon the association's capital position. OTS policy also permits management to be granted stock options in an amount up to 10% of the shares issued in the conversion.[13] Finally, the OTS recently, on a case by case basis, has imposed specific percentage limitations on the amount of stock that may vest with individual officers and directors.

Given that mutual savings associations currently seeking to convert generally are well-capitalized, the OTS has become increasingly concerned that the association's management may be undertaking conversions for reasons other than the need for capital. Some thrift insiders may be sacrificing the interests of their associations and mutual account holders to acquire significant amounts of conversion stock and other benefits as cheaply as possible in the conversion process. In addition, in some cases the issuance of conversion stock to a MRP lessens the opportunity for depositors to obtain conversion stock. Finally, the issuance of stock options at the conversion price, rather than at aftermarket trading prices, which in recent years has been substantially higher than the conversion price, creates the impression that management is structuring an excessive compensation package. While the OTS believes there are valid business reasons for thrifts to adopt MRPs and stock option plans in order to attract and retain qualified management, these plans are now more appropriately implemented subsequent to the conversion and with shareholder approval.

The OTS is therefore substantially revising and codifying its policies regarding the establishment of MRPs and stock option plans during the conversion process in new § 563b.3(g)(4). The new provisions require that any decision to implement MRPs or stock option plans after conversion be voted on and approved by a majority of the shareholders no earlier than the first annual meeting following the conversion. The rule further requires that thrift subsidiaries of mutual holding companies obtain a vote of a majority of stockholders, other than the parent mutual holding company, to approve such plans.[14] The provisions also prohibit the use of conversion stock to fund MRPs, require that MRPs be awarded and stock options be granted only after shareholder approval is received and require that stock options be granted at the market price at which the stock is trading at the time of grant. In addition, any intention by management to implement MRPs or stock option plans within one year of conversion would be (1) required to be fully disclosed in the proxy soliciting and conversion stock offering materials, and (2) subject to the prior approval of the appropriate OTS Regional Director. Finally, the regulation codifies the OTS's current policies regarding permissible amounts that may be included in stock option and MRP plans formed within one year of conversion. Codification of these policies is designed to provide clear guidance in this area.

G. Prohibition on Merger Conversions

Under § 563b.10, a mutual savings association may convert to stock form by merging with an existing stock association or by becoming a subsidiary of an existing holding company. In this type of conversion, the account holders of the mutual savings association, instead of being offered the opportunity to purchase stock of the converting mutual association, are instead offered the opportunity to purchase shares of the acquiring stock association or holding company. The structure of these transactions raises unique issues not involved in other types of conversions. These include the adequacy of the consideration paid by an acquiror, whether a "control premium" should or can be incorporated into the valuation of the mutual savings association; the treatment of the mutual account holders in connection with the distribution of the acquiror's stock; whether mutual account holders should be able to purchase the acquiror's stock at a discount and the amount of such discount; and the appropriateness of management compensation and stock incentive packages offered by an acquiror to coax the mutual association's management into the merger conversion.

When merger conversions were first allowed by the FHLBB in the 1980s, they were perceived to be a useful supervisory tool by which significantly undercapitalized or marginally capitalized savings associations could improve their capital positions. In recent years, however, the OTS began to have increasing concern about merger conversions involving healthy associations. In Thrift Bulletin 58 (April 19, 1993), the OTS established increased disclosure requirements for merger conversion proxy statements to ensure that account holders received adequate and accurate disclosure about proposed merger conversion transactions. In so doing, the OTS asserted its view that merger conversions provide more opportunity than standard conversions for insider abuse.[15] In addition, the OTS voiced concerns that institutions participating in merger conversions were not providing sufficient disclosure to account holders regarding this more complex form of conversion transaction.[16]

In addition, there have been numerous complaints recently by account holders and others that permitting healthy mutual savings associations to be acquired by means of a merger conversion has resulted in some thrift insiders putting their self interest ahead of the interests of the converting association and its account holders.

As a result of these concerns, the OTS recently imposed a moratorium on healthy savings associations entering into these transactions. In its announcement, the OTS stated that the moratorium would not prohibit the acquisition of an undercapitalized thrift by a healthy acquiror.

In undertaking the moratorium, the OTS noted that in many cases, management of the converting mutual savings associations engaging in merger conversions were receiving extremely generous compensation and benefit packages. While OTS rules limit many forms of excessive compensation in merger conversions,[17] there is still an

[12] See FHLBB Office of General Counsel Questions and Answers on Part 563b Conversion and Employee Stock Benefits Plans at 4, 5 (May 1987).

[13] Id.

[14] In this regard, § 10(o)(6)(B) of the HOLA requires that a mutual holding company, which is generally controlled by the management of its thrift subsidiary, must own more than 50% of its thrift subsidiary. Thus, absent a disinterested stockholder vote requirement, management will be able to ensure approval of its compensation plans.

[15] OTS Thrift Bulletin 58, at 1 (April 19, 1993).

[16] Id.

[17] For example, the OTS policy statement on mergers, 12 CFR 571.5, in pertinent part, specifically provides that compensation, including deferred compensation to officers, directors and controlling persons of a merging association may not be in excess of that which is reasonable and commensurate with their duties and responsibilities. The rule provides that mergers will be particularly scrutinized where any such persons will receive a material increase in compensation above that paid by the merging association prior to the commencement of merger negotiations. In this regard, an increase in compensation in excess of the greater of 15% or $10,000 gives rise to

Continued

issue as to whether management is opting for a merger conversion instead of a standard conversion based on the best interests of the association and its depositors or in response to the level of benefits offered to management by the acquiring entity.

In addition, merger conversions are perceived as being overly generous to the acquiring entities since they are essentially able to acquire the mutual association at no cost. Unlike other corporate acquisitions, the acquiror pays nothing for the converting association's stock. Rather, simultaneous with the acquisition, the acquiror's primary obligation is to make an equity offering of its own stock to depositors of the converting association, retaining all proceeds of the offering.

The OTS conversion regulations are based upon the principle that a conversion cannot be equitable unless the potential for "windfall" gains is virtually eliminated. In a standard conversion, the *pro forma* market value of the converting savings association is an appropriate means for determining the price of the stock to be sold. In a merger conversion, however, the acquiring entity is obtaining control and should pay a premium for the *pro forma* value of the stock. In essence, the acquiring entity is obtaining control and receiving a "windfall" gain. As a result, there is tremendous incentive for an acquirer to offer excessive benefits to the management of a mutual savings association to participate in a merger conversion. Upon further review of this issue, the OTS has been unable to resolve the valuation and "windfall" gains problem that the OTS currently believes is inherent in merger conversion transactions.

The OTS therefore has concluded that in nonsupervisory cases, there should be a two step process. The account holders at the mutual association should be given the opportunity to purchase stock in a mutual to stock conversion. This assures the account holders that they will have the opportunity to more directly participate in any appreciation of the converting association's stock price following the conversion. After the conversion to stock form, stockholders can vote on whether to merge with another institution, subject to the rules governing post-conversion transactions.

Based on the reasons described above, the OTS has determined to amend its conversion regulations to limit merger conversions to supervisory cases. As noted earlier, merger conversions may serve a useful purpose in those cases where a savings association is unable to convert on a stand alone basis because of its weak financial condition.

While eliminating the authority for nonsupervisory merger conversions in the interim final rule, the OTS is soliciting comment as to whether merger conversions involving healthy savings associations should be permitted in the future, and if so, under what circumstances. In particular, the OTS is interested in receiving comments on how merger conversions could be structured to avoid the problems discussed above, including the problems associated with valuation issues.

H. Extension of the Conversion Public Comment Period

Section 563b.4(b)(1) requires a conversion applicant to publish, in writing, a notice of the filing of an application. Pursuant to the rule, written comments, including objections to the plan of conversion and materials supporting the objections, from any member of the applicant or aggrieved person will be considered by the OTS if filed within ten business days after the date of this notice. Failure to provide the written comments within the ten day period may preclude the pursuit of any administrative or judicial remedies.

Depositors of converting associations and community groups have become increasingly interested in expressing their views on proposed conversions, usually through the public comment process. In this regard, the current ten day comment period may not be sufficient time for interested parties to review and comment on a detailed conversion application. Thus, the OTS is revising § 563b.4(b)(1) to conform the public comment period in the conversion regulations with the longer twenty calendar day public comment period provided under the acquisition of control regulations.[18] The revision also would permit the OTS, in its discretion and upon written request, to extend the twenty day comment period for an additional twenty days. The OTS believes that this revision will give interested parties a more meaningful opportunity to express their views on a proposed conversion transaction. In so doing, the OTS does not believe this requirement will impose an undue burden, since most converting associations undertake holding company conversions, i.e., where a holding company is being formed in the transaction, and are subject to the time periods under the acquisition of control regulations.

I. Submission of Business Plans for All Conversion Transactions

The OTS conversion regulations do not require business plans in standard mutual to stock conversion transactions. The OTS acquisition of control regulations, however, do require a consolidated business plan conforming to the requirements set by the Regional Director to be included in holding company conversions.[19] Because most converting associations also form a holding company at the time of the conversion, most converting associations currently file a business plan.

The OTS believes that all converting associations should be required to demonstrate how they will prudently deploy and utilize the conversion proceeds. Therefore, the exhibits portion of the conversion application form, Form AC, is being amended to require a new Exhibit 8, a consolidated business plan subject to approval by the Regional Director. Also, in response to the OTS's experience that a number of associations have recently submitted business plans that do not adequately address the deployment of conversion proceeds, the new Exhibit 8 includes a requirement that each converting association provide, as part of the business plan submitted with the application for conversion, a detailed discussion of how the capital acquired in the conversion will be utilized. If the plan is to be treated confidentially, the applicant should follow the procedures set forth at § 563b.4(c).

J. Revision to Post-Conversion Stock Repurchase Rules

The capital distributions regulation[20] and § 563b.3(g)(3) of the conversion regulations provide that a well capitalized converted association can repurchase its capital stock, within certain limits and restrictions, by filing with the Regional Director an open-market stock repurchase program for no more than 5% of the association's outstanding capital stock during a six month period. This provision is in essence a safe harbor, provided an institution is well capitalized.[21] Section 563b.3(g)(3) also provides that OTS may object to proposed repurchases fitting within the safe harbor if the repurchases would adversely affect the financial condition of the thrift.[22] Provided the

presumptions of unreasonableness and sale of control. See 12 CFR 571.5(d)(3).

[18] 12 CFR part 574.

[19] 12 CFR 574.6(a)(1)(ii).

[20] 12 CFR 563.134.

[21] 12 CFR 563.134(b).

[22] 12 CFR 563b.3(g)(3)(i)(A).

safe harbor is met, a converted association can, under current rules, buy back up to 30% of the stock sold in the conversion within three years of conversion.

The agency's experience has been that many associations begin substantial buyback programs immediately following their conversions. While OTS believes that stock repurchase programs may serve valid business purposes, e.g., maintaining the value of a converting institution's stock in an active trading market, the OTS has concerns that substantial buyback programs begun immediately after conversion may not have a valid business purpose. In addition, repurchases begun immediately after conversion raise substantial issues regarding whether conversion stock has been appropriately valued.

To address these concerns, Form AC has been revised to now require that each converting association provide, as part of the business plan submitted with the application for conversion, a detailed discussion of how the capital acquired in the conversion will be utilized, including, among other things, any proposed stock repurchases.

Also, the OTS is revising § 563b.3(g)(3) to prohibit stock repurchases for one year following conversion. After one year, a recently converted association may file with the appropriate Regional Director an open-market repurchase program in which it can request stock repurchases of no more than 5% of the outstanding capital stock during any twelve month period within the following two years. In addition to the current standards governing permissible repurchases, the Regional Director can now disapprove repurchases if the association does not demonstrate a valid business purpose for the stock repurchase. This regulation, however, will permit the Regional Director to approve amounts greater than 5% in the second and third years if there are circumstances that would justify such repurchases. Section 563b.3(g)(1)(iii) has been deleted to conform with this revision.

The OTS also is soliciting comments as to whether the current requirements of the capital distributions regulations governing the "upstreaming" of conversion proceeds to holding companies formed by converting institutions should be revised to further restrict the upstreaming of substantial amounts of the conversion proceeds soon after the conversion.

K. Other Issues

1. Subscription Rights

The conversion regulations require that prior to the completion of a conversion, no person may transfer, or enter into any agreement or understanding to transfer, the legal or beneficial ownership of conversion subscription rights, or the underlying securities to the account of another.[23]

The OTS notes that the FDIC and others have recently suggested that it may be appropriate for depositors to be able to transfer and sell their subscription rights so that any "windfall" value can be distributed directly to the depositors.

In this regard, the OTS believes that this type of change to the current conversion regulations would raise a number of novel and complex legal and policy issues, many of which were taken into account previously by the FHLBB in determining to prohibit transferability. These issues include the possibility of adverse federal tax consequences to depositors receiving such rights, undue pressure on mutual associations to convert that may evolve from significant shifts of savings funds by depositors into such associations, difficulties in equitably allocating such subscription rights among depositors, potential manipulation of the process by sophisticated third parties to the detriment of the depositors, incentives for manipulation by insiders, the continued need for establishment and maintenance of a liquidation account,[24] and significantly increased conversion costs due to compliance with securities laws requirements for registering subscription rights for public distribution.

The OTS believes these issues must be carefully analyzed before considering regulatory changes in this area. Therefore, the OTS is not proposing any change at this time that would allow for the transfer or sale of subscription rights, but is requesting comment on whether subscription rights should continue to be nontransferable, or if transferability is recommended, the reasons for, and the manner in which to allow for, such transfer.

[23] 12 CFR 563b.3(i)(1).

[24] The regulations require that a converting association establish and maintain a liquidation account for the benefit of eligible account holders and supplemental eligible account holders in an amount equal to the association's net worth at the date of conversion. Each eligible account holder is deemed to have a pro rata inchoate interest in the liquidation account. In the event of a complete liquidation of the association, an account holder's interest may not be increased after conversion, but may be reduced by any subsequent decrease in the account holder's savings account balance. See 12 CFR 563b.3(c)(13).

2. Availability of Conversion Documents

The conversion regulations, since adoption in 1974, have prohibited the placing of copies of preliminary conversion stock offering and proxy soliciting materials in the OTS public files. The OTS has noted, over the past few years, an increasing interest shown by account holders, the public and the media in the information contained in those portions of an application for conversion.

The OTS believes that even though this information is preliminary in nature, it may be useful for account holders and the public to access it earlier in the conversion process. The OTS, therefore, is revising § 563b.4(c) to eliminate the automatic confidential treatment that has been afforded this information in the past. The revision will permit the public to have ready access to all relevant materials regarding proposed conversion transactions.[25] Applicants will have the ability to request confidential treatment of any portion of these materials by following the confidential treatment procedures contained in section 563b.4(c).

3. Conforming Changes to Mutual Holding Company Regulations and Other Technical Changes

The mutual holding company regulations, 12 CFR part 575, generally incorporate the substantive and procedural standards for conversion contained in the conversion regulations. To the extent the interim final rule addresses conversion standards, those same standards apply to mutual holding company transactions. Thus, the OTS is also revising 12 CFR part 575 to make clarifying and conforming changes to those regulations to reflect the changes being made to 12 CFR part 563b.

Also, the interim final rule makes certain other technical and conforming changes to the conversion regulations.

4. Proposal to Impose Convenience and Needs Test in Conversion Transactions

Elsewhere in this issue of the Federal Register, the OTS is soliciting public comment on an amendment to its conversion regulations that would impose an additional standard requiring that the OTS, in considering whether to

[25] This revision augments the amount of information regarding conversions currently required to be made public by converting associations. Section 563b.4(a)(3)(ii) requires that, promptly after adoption of a plan of conversion by its board of directors, a converting association must notify its members and make copies of the adopted plan of conversion available for inspection by its members at each office of the savings association. Section 563b.4(a)(3)(ii) also allows a converting association to issue a press release announcing the conversion.

approve a mutual to stock conversion transaction, consider the needs and convenience of the community served by the converting association. To date, a convenience and needs test generally has not been applied to these transactions.

III. Paperwork Reduction Act

The reporting requirements contained in this interim final rule have been submitted to and approved by the Office of Management and Budget under OMB Control No. 1550–0014 in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3507). Comments on the collection of information should be sent to the Office of Management and Budget, Paperwork Reduction Project (1550), Washington, DC 20503 with copies to the Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

The reporting requirements in this interim final rule are found in 12 CFR 563b.100. The information is needed by the OTS to further strengthen the standards governing the conversion process. The likely recordkeepers are savings associations.

Estimated number of respondents: 70.

Estimated average annual burden per respondent: 500.

Estimated annual frequency of responses: 1.

Estimated total annual reporting burden: 35,000.

IV. Regulatory Flexibility Act

Because no notice of proposed rulemaking was required in connection with the adoption of this interim final rule, no regulatory flexibility analysis is required under the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*).

V. Executive Order 12866

The OTS has determined that the interim final regulation does not constitute a "significant regulatory action" for purposes of E.O. 12866.

VI. Administrative Procedure Act

Pursuant to 5 U.S.C. 553, OTS has found good cause to dispense with both prior notice and comment on this interim final rule and with a 30-day delay of its effective date in light of the critical need to ensure an equitable conversion process while still providing converting associations access to the capital markets. The OTS has a number of conversion applications pending and it expects that it will receive significantly more in the next few weeks. Unless these revisions are implemented immediately, associations will be able to avoid compliance with the new rules by filing and attempting to obtain approval of their conversion applications before the new rules become effective. If the OTS were to proceed with a notice of proposed rulemaking, the only practical solution to this problem would be to impose an administrative moratorium on all conversions until the rulemaking process is complete. That type of rulemaking process would take a minimum of several months. The result would thus be to preclude converting savings associations from raising additional capital at a time when the capital markets are receptive to capital stock offerings by financial institutions. Should the capital markets become less favorable, such a delay could prevent savings associations from raising sufficient new capital through a mutual to stock conversion. The public interest is served by encouraging savings associations to raise additional capital because an association's capital is the financial cushion that protects the association's depositors and the federal fund that insures the depositors' accounts. In view of the need both to ensure an equitable conversion process and to provide converting associations with access to the capital markets without delay, the OTS finds that good cause exists for dispensing with the notice and comment procedures of the Administrative Procedure Act. Similarly, the OTS finds that good cause exists for eliminating the 30-day delay of the effective date.

The revised rules will become effective upon publication in the Federal Register and will be applicable to all applications pending or newly filed as of that date. The OTS generally expects converting associations with pending applications to comply with the revised rules. The OTS may grant, on a case by case basis, a waiver in writing from any provision in the interim final rule for good cause shown. The request for a waiver must contain sufficient information to substantiate the justification for the waiver.

The OTS, however, seeks public comment on the conversion regulations, both as to the amendments adopted here and the issues on which comment is specifically solicited and as to any other current provisions of the conversion regulations as they relate to this interim final rule. The OTS may modify the rule in response to those comments if appropriate.

List of Subjects

12 CFR Part 563b

Reporting and recordkeeping requirements, Savings associations, Securities.

12 CFR Part 575

Capital, Holding companies, Reporting and recordkeeping requirements, Savings associations, Securities.

For the reasons set out in the preamble, parts 563b and 575 of subchapter D, chapter V, title 12 of the Code of Federal Regulations are amended as follows:

SUBCHAPTER D—REGULATIONS APPLICABLE TO ALL SAVINGS ASSOCIATIONS

PART 563b—CONVERSIONS FROM MUTUAL TO STOCK FORM

1. The authority citation for 12 CFR part 563b continues to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a; 15 U.S.C. 78c, 78l, 78m, 78n, 78w.

2. Section 563b.2 is amended by removing paragraph (a)(14); by redesignating paragraphs (a)(15) through (a)(19) and (a)(29) through (a)(40) as paragraphs (a)(14) through (a)(18) and paragraphs (a)(30) through (a)(41), respectively; by revising paragraph (a)(16); and by adding paragraphs (a)(19) and (a)(29) to read as follows:

§ 563b.2 Definitions.

(a) * * *

(16) *Eligible account holder.* The term *eligible account holder* means any person holding a qualifying deposit as determined in accordance with § 563b.3(e) of this part, but shall include only those account holders with savings accounts in place for a minimum of one year prior to board of director adoption of the plan of conversion.

* * * * *

(19) *Local community.* The term *local community* includes all counties in which the converting association has its home office or a branch office, each county's standard metropolitan statistical area or the general metropolitan area of each of these counties and such other similar local area(s) as provided for in the plan of conversion, as approved by the OTS.

* * * * *

(29) *Regional Director.* The term *regional director* means the senior representative of the Director of the Office of Thrift Supervision for all matters dealing with examination and supervision of savings associations in the region in which the converting savings association has its principal office.

* * * * *

3. Section 563b.3 is amended by:

a. Revising paragraphs (c)(6)(i), (c)(6)(iv), (c)(7), (c)(14), (c)(23), (d)(4), (g) heading, (g)(1)(i) and (g)(1)(ii) and (g)(3);

b. Redesignating paragraphs (c)(2)(i), (c)(2)(ii), (c)(4)(i) through (c)(4)(iv), (c)(5)(i) and (c)(5)(ii) as paragraphs (c)(2)(ii), (c)(2)(iii), (c)(4)(ii) through (c)(4)(v), (c)(5)(ii) and (c)(5)(iii), respectively;

c. Removing paragraph (g)(1)(iii); and

d. Adding new paragraphs (c)(2)(i), (c)(4)(i), (c)(5)(i), and (g)(4).

The additions and revisions read as follows:

§ 563b.3 General principles for conversions.

* * * * *

(c) * * *

(2) * * *

(i) The stock to be offered and sold in the subscription offering shall give a preference to eligible account holders residing in the association's local community or within 100 miles of the association's home or branch office(s).

* * * * *

(4) * * *

(i) The stock to be offered and sold in the subscription offering shall give a preference to supplemental eligible account holders residing in the association's local community or within 100 miles of the association's home or branch office(s).

* * * * *

(5) * * *

(i) The stock to be offered and sold in the subscription offering shall give a preference to voting members residing in the association's local community or within 100 miles of the association's home or branch office(s).

* * * * *

(6) * * *

(i) Subject to the adoption in the plan of conversion of the optional provision of paragraph (d)(4) of this section, a condition limiting purchases in the public offering or the direct community offering by any person together with any associate or group of persons acting in concert to not more than five percent (5%) of the total offering of shares, except that any one or more tax-qualified employee benefit plans may purchase in the aggregate not more than ten percent (10%) of the total offering of shares. Shares held by one or more tax-qualified employee benefit plans and attributed to a person shall not be aggregated with other shares purchased directly by or otherwise attributable to that person.

* * * * *

(iv) A condition that any direct community offering by the converting savings association shall give a preference to natural persons residing in the association's local community or within 100 miles of the association's home or branch office(s).

(7) Subject to the adoption in the plan of conversion of the optional provision of paragraph (d)(4) of this section, provide that the total shares that any person and any associate or group of persons acting in concert may subscribe for or purchase in the conversion shall not exceed five percent (5%) of the total offering of shares, except that any one or more tax-qualified employee benefit plans may purchase in the aggregate not more than ten percent (10%) of the total offering of shares. Shares held by one or more tax-qualified employee benefit plans and attributed to a person shall not be aggregated with shares purchased directly by or otherwise attributable to that person.

* * * * *

(14) Provide for an eligibility record date, which shall be not less than one year prior to the date of adoption of the plan of conversion by the converting savings association's board of directors.

* * * * *

(23) Provide that eligible account holders with subscription rights have priority to purchase conversion stock prior to tax-qualified employee stock benefit plans and tax-qualified employee stock benefit plans have priority to purchase conversion stock prior to supplemental eligible account holders and other voting members who have subscription rights. If shares are sold in the conversion stock offering in excess of the maximum proposed offering, shares may be sold to the tax-qualified employee stock benefit plans in accordance with the purchase limitations provided in paragraph (c)(7) of this section.

* * * * *

(d) * * *

(4) That purchases in the public offering or in the direct community offering by any person together with any associate or group of persons acting in concert shall be limited to less than ten percent (10%) of the total offering of shares. The percentage amount by which any order for conversion stock exceeds 5% of the total offering of shares shall be aggregated with the percentage amounts by which all other orders for conversion stock exceed 5% of the total offering of shares. The aggregate amount shall not exceed 10% of the total offering of shares, except that this limitation shall not apply to the purchases of the tax-qualified employee stock benefit plans.

* * * * *

(g) Restrictions on repurchase of stock; payment of dividends; and use of stock option and management or employee stock benefit plans. * * *

(1) * * *

(i) A repurchase, on a *pro rata* basis pursuant to an offer approved by the Office and made to all shareholders of such association; or

(ii) The repurchase of qualifying shares of a director.

* * * * *

(3)(i) A converted savings association subject to paragraph (g)(1) of this section may repurchase its capital stock provided:

(A) No repurchases occur within one year following conversion;

(B) Repurchases within two years after the conversion are part of an open-market stock repurchase program that does not allow for a repurchase of more than 5% of the association's outstanding capital stock during a twelve month period;

(C) The repurchases do not cause the association to become undercapitalized (as defined in 12 CFR 565.4); and

(D) The association provides to the Regional Director, with a copy to the Chief Counsel's Office, Corporate and Securities Division, no later than ten days prior to the commencement of a repurchase program, written notice containing a full description of the repurchase program to be undertaken, the effect of such repurchases on its regulatory capital position, and a valid business purpose for the repurchase; and the Regional Director does not disapprove the repurchase program based upon a determination that:

(*1*) The repurchase program would materially adversely affect the financial condition of the savings association;

(*2*) The information submitted by the savings association is insufficient upon which to base a conclusion as to whether the association's financial condition would be materially adversely affected; or

(*3*) The association did not demonstrate a valid business purpose for the stock repurchase.

(ii) Notwithstanding paragraph (g)(3)(i) of this section, during the second and third year following conversion, the Regional Director, in accordance with the standards contained in this paragraph, may permit stock repurchases in amounts greater than 5% of the association's outstanding capital stock during a twelve month period.

(4) Use of Stock Option and Management or Employee Stock Benefit Plans. No converted savings association shall, for a one year period from the date

of the conversion, implement a stock option plan or management or employee stock benefit plan, other than a tax-qualified plan complying with (c)(6) of this section, unless each of the following requirements are met:

(i) Each of the plans was fully disclosed in the proxy soliciting and conversion stock offering materials;

(ii) For stock option plans, the total number of shares of common stock for which options may be granted does not exceed ten percent of the amount of shares issued in the conversion;

(iii) For management or employee stock benefit plans, the aggregate amount of such plans shall not exceed three percent of the amount of shares issued in the conversion;

(iv) The aggregate amount of all shares obtained by a tax-qualified employee stock benefit plan(s) in the conversion, pursuant to (c)(6) of this section, or within one year following the conversion, and all the shares in a management or employee stock benefit plan, pursuant to paragraph (g)(4)(iii) of this section, shall not exceed ten percent of the total amount of shares issued in the conversion;

(v) Associations that have in excess of ten percent tangible capital following the conversion, may be granted, on a case by case basis, approval to establish a management or employee stock benefit plan pursuant to paragraph (g)(4)(iii) of this section in an amount up to four percent of the amount of the shares issued in the conversion, and an aggregate total of up to twelve percent for all plans established pursuant to paragraph (g)(4)(iv) of this section;

(vi) No individual shall receive more than twenty-five percent of the shares of any plan and directors who are not employees of the association shall not receive more than five percent of the stock individually, or thirty percent in the aggregate, of any plan;

(vii) All such plans are approved by a majority of the association's stockholders, or in the case of a recently formed holding company, its stockholders, prior to implementation and no earlier than the first annual meeting following the conversion;

(viii) In the case of a savings association subsidiary of a mutual holding company, all such plans are approved by a majority of stockholders other than its parent mutual holding company prior to implementation and no earlier than the first annual meeting following the stock issuance;

(ix) For stock option plans, stock options are granted at the market price at which the stock is trading at the time of grant;

(x) For management or employee stock benefit plans, no conversion stock is used to fund the plans; and

(xi) Prior to implementation, all such plans are submitted to the appropriate Regional Director for review and approval in accordance with the foregoing standards. In connection with such review, the Regional Director shall consider all relevant supervisory information, including, among other things, the association's capital level, operating history and size of the association. The Regional Director may permit amounts greater than those specified in paragraph (g)(4)(vi) of this section, provided that the aggregate limitations of paragraphs (g)(4)(ii)–(v) of this section are not exceeded.

* * * * *

4. Section 563b.4 is amended by removing the phrases "District Director" and "District Director's" where they appear in paragraph (b)(1) and adding in lieu thereof the phrases "Regional Director" and "Regional Director's", respectively; and by revising the concluding text of paragraph (b)(1) following the nouce of filing and paragraph (c) to read as follows:

§ 563b.4 Notice of filing; public statements; confidentiality.

* * * * *

(b) * * *

(1) * * *

Written comments, including objections to the plan of conversion and materials supporting the objections, from any member of the applicant or aggrieved person will be considered by the Office if filed within twenty calendar days after the date of this nouce. The OTS may, in its discretion, and upon written request, extend the twenty day comment period for an additional twenty calendar days. Failure to provide the written comments in twenty calendar days may preclude the pursuit of any administrative or judicial remedies. Two copies of the comments should be sent to the Chief Counsel, Corporate and Securities Division, one copy to the Corporate Activities Division and one copy to the Regional Director. The proposed plan of conversion and any comments will be available for inspection by any member of the applicant at the Chief Counsel's Office and at the Regional Director's Office. A copy of the plan of conversion may also be inspected at the home office and each branch office of the applicant.

* * * * *

(c) Should the applicant desire to submit any information it deems to be of a confidential nature regarding the answer to any item or any part of any exhibit included in any application under this part, such information pertaining to such item or exhibit shall be separately bound and labeled "confidential," and a statement shall be submitted therewith briefly setting forth the grounds on which such information should be treated as confidential. Only general reference thereto need be made in that portion of the application which the applicant deems not to be confidential. Applications under this part shall be made available for inspection by the public, except for portions which are bound and labeled "confidential" and which the Office determines to withhold from public availability under 5 U.S.C. 552 and part 505 of this chapter. Preliminary soliciting materials will be made available upon filing, unless such materials are not otherwise available to the public and are bound and labeled "confidential." The applicant will be advised of any decision by the Office to make public information designated "confidential" by the applicant. Even though sections of the application are considered "confidential," as far as public inspection thereof is concerned, to the extent it deems necessary, the Office may comment on such confidential submissions in any public statement in connection with its decision on the application without prior notice to the applicant.

5. Section 563b.5 is amended by revising paragraphs (d)(4) and (e)(5) to read as follows:

§ 563b.5 Solicitation of proxies; proxy statement.

* * * * *

(d) * * *

(4) Each voting member must be furnished a form of proxy conforming with paragraph (d) of this section. No applicant shall use previously-executed proxies.

(e) * * *

(5) All preliminary copies of material filed pursuant to paragraphs (e)(1), (e)(2) and (e)(4) of this section shall be clearly marked on the cover page "Preliminary Copy". Such preliminary copies shall be public unless otherwise deemed confidential pursuant to § 563b.4(c) of this part.

* * * * *

6. Section 563b.7 is amended by revising paragraphs (f)(1)(ii) and (f)(3), by removing the period at the end of paragraph (f)(1)(iii) and adding a semicolon in its place, and by adding paragraph (f)(1)(iv) to read as follows:

§ 563b.7 Pricing and sale of securities.

(f) * * *

(1) * * *

(ii) The materials shall contain a full appraisal, including a complete and detailed description of the elements that make up an appraisal report, justification for the methodology employed and sufficient support for the conclusions reached therein:

• • • • •

(iv) In those instances where the initial appraisal report is deemed to be materially deficient and/or substantially incomplete, the OTS may deem the entire conversion application materially deficient and/or substantially incomplete, and in accordance with the OTS applications processing rules, 12 CFR part 518, decline to further process the application.

• • • • •

(3) In addition to the information required in paragraphs (f)(1) and (f)(2) of this section, the applicant shall file with the Office such additional information with respect to the pricing of the capital stock of the association as the Office may request.

• • • • •

§ 563b.8 [Amended]

7. Section 563b.8 is amended by removing the phrase "District Director" where it appears in paragraphs (e)(1) and (t)(1), and by adding in lieu thereof the phrase "Regional Director".

8. Section 563b.10 is revised to read as follows:

§ 563b.10 Conversion of a savings association through merger with an existing holding company or stock savings association.

A savings association that qualifies for a voluntary supervisory conversion under subpart C of this part may convert to stock form by merging with an existing holding company or interim Federal or state chartered stock association in a transaction in which stock of the existing holding company or resulting association is issued.

9. Section 563b.100 is amended by removing the phrase "90 days" in Form AC, the first paragraph of Item 6 and by adding in lieu thereof the phrase "one year"; and by adding Exhibit 8 to Form AC to read as follows:

§ 563b.100 Form AC—Application for Conversion.

Form AC

• • • • •

Exhibit 8 Business Plans

(a) Furnish a consolidated business plan. The converting association shall provide, as part of the business plan, a detailed discussion of how the capital acquired in the conversion will be utilized, including, among other things, any proposed stock repurchases.

(b) Applicant should follow § 563b.4(c) if the business plan is to be deemed confidential.

10. Section 563b.101 is amended by revising Items 1 and 4(d) of Form PS to read as follows:

§ 563b.101 Form PS—Proxy Statements.

Form PS

• • • • •

Item 1. Notice of Meeting

The cover page of the proxy statement shall give notice of the meeting of the association members called by the board of directors to act upon the conversion. The cover page shall include the date, time and place of the meeting, a brief description of each matter to be acted upon at the meeting, the date of record for association members entitled to vote at the meeting, the date of the statement and the full address, ZIP code and telephone number of the applicant.

In accordance with § 563b.5(d)(4) of this part, the applicant shall not use previously-executed proxies to vote on the plan of conversion.

• • • • •

Item 4 Voting Rights and Vote Required for Approval

• • • • •

(d) The applicant shall not use previously-executed proxies to vote on the plan of conversion.

• • • • •

PART 575—MUTUAL SAVINGS AND LOAN HOLDING COMPANIES

11. The authority citation for 12 CFR part 575 continues to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1828.

12. Section 575.7 is amended by adding paragraph (e) to read as follows:

§ 575.7 Issuances of stock by savings association subsidiaries of mutual holding companies.

• • • • •

(e) *Procedural and substantive requirements.* The procedural and substantive requirements of §§ 563b.3 through 563b.8 of this subchapter shall apply to all mutual holding company stock issuances under this section, unless clearly inapplicable.

13. Section 575.13 is amended by adding a new sentence at the end of paragraph (a)(4) to read as follows:

§ 575.13 Procedural requirements.

(a) • • •

(4) • • • Notwithstanding the provisions in this paragraph (a)(4), "running" proxies or similar proxies may not be used to vote for a mutual to stock conversion undertaken either by a mutual savings association or a mutual holding company.

• • • • •

Dated: April 7, 1994.

By the Office of Thrift Supervision.

Jonathan L. Fiechter,

Acting Director.

[FR Doc. 94-9981 Filed 5-2-94; 8:45 am]

BILLING CODE 6720-01-P

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AB25

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Management of Investments, Liquidity, Interest Rate Risk, and Eligible Investments; Correction

AGENCY: Farm Credit Administration.

ACTION: Correcting amendments.

SUMMARY: The Farm Credit Administration (FCA) published a final rule (58 FR 63034, November 30, 1993) that amended the regulations which govern the investment activities of Farm Credit System banks. This document corrects two typographical errors in the final rule.

EFFECTIVE DATE: March 15, 1994.

FOR FURTHER INFORMATION CONTACT: Cindy R. Nicholson, Paralegal Specialist, Office of Examination, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4498, TDD (703) 883-4444.

SUPPLEMENTARY INFORMATION: In preparing the final rule for publication in the Federal Register, a typographical error was inadvertently made in the § 615.5140(a)(8)(i)(B) and (a)(11)(ii).

List of Subjects in 12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

Accordingly, 12 CFR part 615 is corrected by making the following correcting amendments:

PART 615—FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS; AND FUNDING OPERATIONS

1. The authority citation for part 615 continues to read as follows:

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act; 12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128

22764

Proposed Rules

Federal Register
Vol. 59, No. 84
Tuesday, May 3, 1994

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Parts 563b and 575

[No. 94-49]

RIN 1550-AA74

Conversions From Mutual to Stock Form; Mutual Savings and Loan Holding Companies

AGENCY: Office of Thrift Supervision.

ACTION: Proposed rule.

SUMMARY: The Office of Thrift Supervision (OTS) proposes to amend its regulations governing mutual to stock conversions and stock issuances by savings association subsidiaries of mutual holding companies (MHC stock offerings). The proposed amendment requires the OTS, in connection with its review of conversion applications and MHC stock offering applications, to consider the extent to which the transaction will affect the convenience and needs of the communities to be served by the applicant. Under the proposal, in determining whether to approve these types of applications, the OTS will consider the applicant's record of compliance with the Community Reinvestment Act (CRA) and other factors relating to the convenience and needs of the communities served by the applicant.

DATES: Comments must be received on or before July 17, 1994.

ADDRESSES: Interested parties are invited to submit written comments on this proposal to: Director, Information Services Division, Public Affairs, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: Docket No. 94-49. These submissions may be hand-delivered to 1700 G Street, NW., from 9 a.m. to 5 p.m. on business days, or may be sent by facsimile transmission to FAX number (202) 906-7755. Comments will be available for inspection at 1700 G Street, NW., from 1 p.m. until 4 p.m. on business days. Visitors will be escorted to and from the Public Reference Room at established intervals.

FOR FURTHER INFORMATION CONTACT: Michael P. Valleily, Senior Attorney (202) 906-6241, Kevin A. Corcoran, Assistant Chief Counsel, (202) 906-6982, Corporate and Securities Division, Chief Counsel's Office; Diana L. Garmus, Deputy Assistant Director, (202) 906-5683, Corporate Activities Division, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

Background

The OTS recently has undertaken a comprehensive review of its conversion regulations. By Order No. 94-48, dated April 7, 1994, the OTS adopted significant amendments to its mutual to stock conversion regulations, 12 CFR part 563b, and mutual holding company regulations, 12 CFR part 575, to revise, update and clarify the regulations in a number of areas. In connection with its review of the conversion regulations, one of the issues the OTS considered was whether the convenience and needs of the local communities should be a factor in determining whether to approve these conversions.

The reasons for mutual associations conversion to stock form have changed over the years. During the 1980s, most mutual savings associations were marginally capitalized and many were insolvent. During this period, conversion transactions were a primary method for undercapitalized savings associations to raise capital and avoid being closed by the regulators. The conversion enabled an association to stay in business and continue to serve the community's credit needs.

Now, however, most mutual associations are healthy. While a relatively small number of capital deficient mutual associations undertake conversions primarily to recapitalize, most healthy mutual thrifts now convert for other reasons. These reasons include financing the expansion of their operations and taking advantage of the benefits available to a public company, such as the ability to establish stock benefit plans for management and employees.

The OTS is aware that account holders and consumer groups recently have voiced significant concerns regarding the conversion of well-capitalized associations, particularly in light of the compensation and stock benefits that management typically receives in such transactions. Such groups also have expressed concerns regarding the proper deployment of conversion proceeds, *i.e.*, the extent to which the capital raised in such transactions should be used to support credit and loan programs and related services tailored to the community's credit needs. In addition, management of many well-capitalized converting associations recently have expressed concern to the OTS that their institutions do not need—or are unable efficiently to deploy—substantial amounts of the capital required to be raised under current regulations.[1] Managers of such associations also have voiced concern about the negative impact of what they view as "excess capital" on the price/earnings ratio of the converted association's stock.

The OTS is responding to these concerns by issuing an interim final regulation that, among other things, restricts management benefit plans and requires converting institutions to file with the OTS a business plan that adequately addresses the deployment of conversion proceeds.[2] The interim rule, which appears elsewhere in this issue of the Federal Register, solicits public comment on the conversion regulations, both as to the amendments adopted there and the issues on which comment is specifically sought, and as to any other current provisions of the conversion regulations as they relate to the interim rule.

As noted in the interim final rule, a convenience and needs standard has not, to date, been applied to mutual stock conversions of savings associations. Similarly, a convenience and needs standard generally has not been applied to MHC stock offerings.[3]

[1] The conversion regulations require that stock be sold in the amount of the converting association's pro forma market value. See 12 CFR 563b.7(f).

[2] See OTS Order No. 94-48.

[3] A convenience and needs standard is already being applied to mutual holdco company reorganizations because these transactions require the OTS's approval under the Bank Merger Act (BMA). See 58 FR 44105 (August 19, 1993) (adopting part 575 governing mutual holding company reorganizations and related stock issuances). The BMA requires that the responsible agency consider the convenience and needs of the community to be served in acting on any BMA application. See 12 U.S.C. 1828(c)(5). Because mutual holding company reorganizations and stock

Upon review of this area, however, the OTS is proposing to apply a convenience and needs standard to these transactions for the reasons discussed below.

First, the OTS has broad authority under sections 5(i)(1) and 5(i)(2) of the Home Owners' Loan Act (HOLA) to regulate mutual to stock conversions by savings associations, and under section 10(o)(7) of the HOLA to regulate mutual holding companies.[4] These authorities give the agency considerable discretion in reviewing a conversion application or MHC stock offering application. For example, the OTS has exercised this authority to determine whether a transaction is in the best interests of depositors, the association and the Savings Association Insurance Fund.[5] The OTS believes that inherent in this broad grant of authority is the ability to assess the impact of a proposed transaction on the convenience and needs of the communities to be served by a savings association.

Second, section 4(a)(3) of the HOLA supports the adoption of the proposed regulations addressing housing credit needs.[6] Section 4(a)(3) of the HOLA provides that the Director "shall exercise all powers granted to the Director under this chapter so as to encourage savings associations to provide credit for housing safely and soundly." The powers granted to the Director include the general regulatory authority under sections 5(i)(1), 5(i)(2), and 10(o)(7) of the HOLA mentioned above. Because savings associations are predominantly housing lenders, the admonition in section 4(a)(3) of the HOLA that the Director use his or her statutory powers to encourage savings associations to provide credit for housing provides a substantial additional basis for the Director to assess community needs when reviewing applications.

Third, the OTS believes it is appropriate to apply a convenience and needs standard to conversion transactions and MHC stock offerings as a part of the OTS's responsibility to consider the ongoing CRA performance of savings associations. The CRA expresses Congress's judgment that regulated financial institutions must demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business and that regulated financial institutions have continuing and affirmative obligations to help meet the credit needs of those local communities.[7]

In this regard, the federal banking agencies recently conducted a comprehensive review of their CRA regulations in order to provide clearer guidance to financial institutions on the nature and extent of their CRA obligations, the methods by which their performance will be assessed, and the manner in which the CRA will be enforced. This review was undertaken in response to the President's July 1993 request that the federal financial institution supervisory agencies reform the CRA examination and enforcement system. The President asked, among other things, that in undertaking this effort, the regulators seek to promote consistency and even-handedness, to improve CRA performance evaluations and to institute more effective sanctions against institutions with consistently poor CRA performance.[8] The addition of a convenience and needs factor to the mutual to stock conversion standards and the standards for MHC stock offerings is wholly consistent with the larger Presidential and regulatory initiatives on the CRA.[9] The OTS's assessment of the CRA performance record of each association that is subject to the regulations promulgated under sections 5(i) and 10(o) of the HOLA furthers its responsibility under section 4(a)(3) of the HOLA to encourage thrifts to provide housing credit safely and soundly.[10]

The proposed convenience and needs standard, like the convenience and needs standards governing transactions subject to the Bank Merger Act,[11] certain holding company applications,[12] and certain non-routine corporate transactions under current OTS regulations,[13] is intended to encourage savings associations to devote their resources to lending programs and related customer services that are designed to address the credit needs of their local communities, including low- and moderate-income communities, consistent with safety and soundness. Such programs and services are an integral part of a mutual association's traditional role of providing "credit for housing," as envisioned by section 4(a)(3) of the HOLA. Thus, the OTS believes the proposed regulations will enhance the OTS's ability to ensure that savings associations undertaking these transactions recognize their responsibility to consider their community's credit needs.

Proposed Amendments

The proposal would add a new § 563b.11 to the OTS conversion regulations that would require the OTS, in reviewing a conversion application, to examine the extent to which the proposed conversion will affect the convenience and needs of the communities to be served by the converted savings association.

As part of this examination, the OTS will review the applicant's record under the CRA regulations at 12 CFR part 563e and related CRA policies. Under the proposal, the OTS would give substantial weight to an applicant's previous CRA record, consistent with the long-standing policy of the OTS.[14] For example, if an applicant in its most recent CRA examination received a rating of "substantial noncompliance,"[15] the OTS likely would not approve the application.

Under the proposal, the OTS also would scrutinize the business plans of the applicant. Applicants must demonstrate that their plans for deployment of proceeds will help meet the credit and lending needs of the communities served by the applicant. Under the proposed convenience and needs standard, where an applicant's business plan does not adequately address this issue, the OTS may deny the application or impose additional conditions of approval. While commitments in an applicant's business plan to allocate resources to community

---

issuances to date generally have been effected simultaneously as a two part transaction. the OTS has, as a practical matter, reviewed the entire transaction under a convenience and needs standard.

[4] See 12 U.S.C. 1464(i)(1), 1464(i)(2) and 1467a(o)(7). See also *Charter Federal S. & L. Ass'n v. Office of Thrift Supervision*, 912 F.2d 1569 (11th Cir. 1990).

[5] See *Charter Federal; York v. Fed. Home Loan Bank Bd.*, 824 F.2d 495 (4th Cir. 1980), cert. denied 449 U.S. 1043 (1980).

[6] 12 U.S.C. 1463(a)(3).

[7] 12 U.S.C. 2901.

[8] To implement the President's initiative, the four agencies held a series of seven public hearings across the country, and amendments to the agencies' CRA regulations were proposed on December 21, 1993. See 58 FR 67466 (December 21, 1993).

[9] In connection with its review of the CRA and its implementing regulations, the OTS also concluded that the CRA, by its terms, requires the OTS to consider the CRA record of an association proposing to convert from mutual to federal stock form because the association must receive a new federal stock charter to replace its previous mutual charter. See 12 U.S.C. 2902(3)(A) and 2903 and 12 CFR 563e.4(e) (1993).

[10] See also section 5(a) of the HOLA, 12 U.S.C. 1464(a). Section 5(a) of the HOLA provides that the lending and other powers conferred on federal savings associations under section 5 are intended to encourage provision of credit for housing safely and soundly.

[11] See 12 U.S.C. 1828(c).

[12] See 12 U.S.C. 1467a(e)(2).

[13] See 12 CFR 563.22(c) and 571.5(b)(4) (1993).

[14] See 54 FR 13742 (April 5, 1989) (joint CRA policy statement of the federal financial supervisory agencies).

[15] See 55 FR 16163 (May 1, 1990) (adopting revised CRA guidelines and assessment rating system).

development projects or credit-related programs generally indicate responsiveness to the convenience and needs of the community, the OTS will not necessarily view such commitments as remedying CRA-related deficiencies. Performance under those commitments, however, would be considered in evaluating the association's CRA record. The OTS also will consider other relevant factors relating to the association's performance in meeting the convenience and needs of the community.

The proposal also would add a new § 575.7(a)(7) to the OTS's mutual holding company regulations, and renumber current § 575.7(a)(7) as 575.7(a)(8). The proposed new section would set forth an additional approval requirement for stock issuances by a savings association subsidiary of a mutual holding company, requiring that the transaction meet the convenience and needs standard of proposed § 563b.11.

Solicitation of Comments

The OTS solicits comment on all aspects of the proposed regulations. The OTS particularly invites comments on whether the proceeds from conversions or MHC stock offerings should be directed to specific types of activities and, if so, what portion should be used for what types of activities.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, it is certified that this proposal will not have a significant economic impact on a substantial number of small entities. Accordingly, a Regulatory Flexibility Analysis is not required.

Executive Order 12866

The OTS has determined that this rule does not constitute a "significant regulatory action" for purposes of Executive Order 12866.

List of Subjects

12 CFR Part 563b

Reporting and recordkeeping requirements, Savings associations, Securities.

12 CFR Part 575

Capital, Holding companies, Reporting and recordkeeping requirements, Savings associations, Securities.

Accordingly, the Director of the OTS hereby proposes to amend parts 563b and 575, chapter V, title 12, Code of Federal Regulations, as set forth below:

SUBCHAPTER D—REGULATIONS APPLICABLE TO ALL SAVINGS ASSOCIATIONS

PART 563b—CONVERSIONS FROM MUTUAL TO STOCK FORM

1. The authority citation for part 563b is revised to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 2901; 15 U.S.C. 78c, 78l, 78m, 78o, 78w.

2. Section 563b.11 is added to subpart A to read as follows:

§ 563b.11 Convenience and needs considerations.

In reviewing an application under this subpart, the Office will examine the extent to which the conversion will affect the convenience and needs of the communities to be served by the converted savings association. The Office will review the applicant's record under part 563e of this subchapter. In addition, the Office will scrutinize the business plan of the applicant. Each applicant must demonstrate that the proposed deployment of proceeds contained in its business plan will help meet the credit and lending needs of the communities served by the applicant. Also, the Office will consider other relevant factors relating to the association's performance in meeting the convenience and needs of the community. Based on an assessment of the applicant's record under part 563e of this subchapter, the applicant's business plan and other relevant factors, the Office may approve the application, deny the application, or approve the application on the condition that the applicant improve certain aspects of its CRA performance record or address particular credit or lending needs of the communities that it serves.

PART 575—MUTUAL SAVINGS AND LOAN HOLDING COMPANIES

3. The authority citation for part 575 is revised to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1828, 2901.

4. Section 575.7 is amended by redesignating paragraph (a)(7) as paragraph (a)(8), and by adding a new paragraph (a)(7) to read as follows:

§ 575.7 Issuances of stock by savings association subsidiaries of mutual holding companies.

(a) *Approval requirements.* * * *

* * * * *

(7) The proposed stock issuance would fail to meet the convenience and needs standard of § 563b.11 of this subchapter.

* * * * *

Dated: April 8, 1994.

By the Office of Thrift Supervision.

Jonathan L. Fiechter,

Acting Director.

[FR Doc. 94-9980 Filed 5-2-94; 8:45 am]

BILLING CODE 6720-01-P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 25

[Docket No. NM-95; Notice No. SC-94-2-NM]

Special Conditions: Learjet Inc., Model 45 Airplane, Lightning and High-Intensity Radiated Fields

AGENCY: Federal Aviation Administration, DOT.

ACTION: Notice of proposed special conditions.

SUMMARY: This document proposes special conditions for the Learjet Inc. (Learj) Model 45 airplane. This new airplane will utilize new avionics/electronic systems that provide critical data to the flightcrew. The applicable regulations do not contain adequate or appropriate safety standards for the protection of these systems from the effects of lightning and high-intensity radiated fields. These proposed special conditions contain the additional safety standards that the Administrator considers necessary to establish a level of safety equivalent to that established by the existing airworthiness standards.

DATES: Comments must be received on or before June 17, 1994.

ADDRESSES: Comments on this proposal may be mailed in duplicate to: Federal Aviation Administration, Office of the Assistant Chief Counsel, Attn: Rules Docket (ANM-7), Docket No. NM-95, 1601 Lind Avenue SW., Renton, Washington, 98055-4056; or delivered in duplicate to the Office of the Assistant Chief Counsel at the above address. Comments must be marked: Docket No. NM-95. Comments may be inspected in the Rules Docket weekdays, except Federal holidays, between 7:30 a.m. and 4 p.m.

FOR FURTHER INFORMATION CONTACT: Mark Quam, FAA, Standardization Branch, ANM-113, Transport Airplane Directorate, Aircraft Certification Service, 1601 Lind Avenue SW., Renton, Washington, 98055-4056, or telephone (206) 227-2145.

BOSTON PUBLIC LIBRARY
3 9999 05981 934 0

ISBN 0-16-044263-X